

## Chapter 3

# The Theoretical Basis for the Implementation of CSR Principles Through Legal Regulation

There are many ways of examining CSR, although as yet there is no single generally accepted, fully specified concept encompassing its practices. Contemporary scholars of CSR have shown that the voluntary mode of practising CSR is predominant. However, there are opponents of this mode, especially in the weak economies in which the non-legal drivers in society are sparse. In these circumstances, establishing a theoretical basis for implementing CSR through legislation is difficult, but important. It is difficult, since legal regulation could be detrimental to business development if it narrows the scope of innovation in business and becomes a barrier to companies' usual business practices in the post-regulatory world. It is important, since the public interest groups—who are sceptical of the role of companies' voluntary responsibility for social development—need a theoretical basis to demonstrate instances of corporate irresponsibility to society in an articulate manner. This chapter presents a detailed discussion of several theories to establish that a normative basis exists for implementing CSR principles through legal regulation.

### 3.1 Introduction

There are many theoretical explanations for why business organisations engage (or not) in CSR practices, including political economy theory, legitimacy theory, the concept of sustainable development, the concept of new governance (NG), stakeholder theory, decision usefulness theory, positive accounting and agency theory. However, in this chapter, decision usefulness theory, positive accounting, and agency theory are not discussed. These three theories explain CSR motivation but do not adopt broader perspectives by considering the wider set of stakeholders. Rather, these functionalist economic theories mostly focus on the financial stakeholders and consider only the market outcomes that run counter to the

principal concerns of CSR practices.<sup>1</sup> This chapter contends that social and political theories such as legitimacy, NG, and stakeholder theory provide far more interesting and insightful theoretical perspectives on CSR practices. These theories are essential for the notion of CSR to respond to the expectations of society. The following discussion examines these theories with the aim of explaining the philosophical basis of why, and to what extent, CSR principles can be incorporated into corporate regulation.<sup>2</sup>

## 3.2 CSR Through Legal Regulation: ‘Legitimacy’ Arguments

The role of business in society is considered as an inherently normative issue that ‘explains what companies should or should not do on behalf of the social good.’<sup>3</sup> It is related to the dimension of civil rights and the broader ethical context from a societal perspective.<sup>4</sup> In society, the norms for business are not fixed; they change

<sup>1</sup> Rob Gray, Reza Kouhy and Saimon Lavers, ‘Corporate Social and Environmental Reporting: A Review of the Literature and A Longitudinal Study of UK Disclosure’ (1995) 8(2) *Accounting, Auditing & Accountability Journal* 47 in Ataur Rahman Belal, *Corporate Social Responsibility Reporting in Developing Countries: The Case of Bangladesh* (2008) 11. For a detailed discussion on the theoretical consideration of corporate motivation for CSR, see Belal, above, 11–27.

<sup>2</sup> For details of these theories, see, for example David Campbell, ‘Legitimacy Theory or Managerial Reality Construction? Corporate Social Disclosure in Marks and Spencer Plc Corporate Reports, 1969–1997’ (2000) 24(1) *Accounting Forum* 80; Gray R, Owen D and Maunders K, *Corporate Social Reporting: Accounting and Accountability* (1987); James Guthrie and Lee D Parker, ‘Corporate Social Reporting: A Rebuttal of Legitimacy Theory’ (1989) 19(7) *Accounting and Business Research*; Markus Milne and Dennis Patten, ‘Securing Organisational Legitimacy: An Experimental Decision Case Examining the Impact of Environmental Disclosures’ (2002) 15 (3) *Accounting, Auditing and Accountability Journal*; Marc Newson and Craig Deegan, ‘Global Expectations and their Association with Corporate Social Disclosure Practices in Australia, Singapore and South Korea’ (2002) 37(2) *International Journal of Accounting* 183; Gray O’Donovan, ‘Environmental Disclosures in the Annual Report: Extending the Applicability and Predictive Power of Legitimacy Theory’ (2002) 15(3) *Accounting, Auditing and Accountability Journal* 344; Dennis Patten, ‘Intra-industry Environmental Disclosures in Response to the Alaskan Oil Spill: A Note on Legitimacy Theory’ (1992) 15(5) *Accounting, Organisations and Society* 471; Mitchell William, ‘Voluntary Environmental and Social Accounting Disclosure Practices in the Asia-Pacific Region: An International Empirical Test of Political Economy Theory’ (1999) 34 (2) *International Journal of Accounting* 209; Trevor Wilmshurst and Geoffrey Frost, ‘Corporate Environmental Reporting: A Test of Legitimacy Theory’ (2000) 13(1) *Accounting, Auditing and Accountability Journal* 10.

<sup>3</sup> Diane Swanson, ‘Toward an Integrative Theory of Business and Society: A Research Strategy for Corporate Social Performance’ (1999) *Academy of Management Review* 506.

<sup>4</sup> Drik Matten and Andrew Crane, ‘Corporate Citizenship: Toward an Extended Theoretical Conceptualisation’ (2005) *Academy of Management Review* 166; Van Oosterhout, ‘Corporate Citizenship: An Idea Whose Time Has Not Yet Come’ (2005) 30(4) *Academy of Management Review* 677.

over time.<sup>5</sup> Entrenching this change as a central theme, arguments for 'legitimacy' maintain that business organisations need to be responsive to changing social expectations to be perceived as legitimate.<sup>6</sup> This is because business organisations can only continue operating as long as their value systems are considered congruent with their society's value system.<sup>7</sup> Society holds this power, as it is the source of the legal status of business organisations, and it provides authority and the rights to resources for business operations. Organisations cannot acquire these resources automatically; they must establish that benefits from their operations can be expected by society, and that these benefits exceed their cost.<sup>8</sup> Thus, the dynamics of acquiring legitimacy in society do not depend on technological and material imperatives, but rather stem from social customs, norms, beliefs and rituals.<sup>9</sup>

However, corporate society does not adequately reflect these arguments. With their apolitical role based on compliance with national laws, corporate organisations limit their social liabilities to the relatively homogeneous and stable societal expectations. They consider social legitimacy at the cognitive level; they deal with legitimacy issues pragmatically and do not consider these issues at their moral or ethical levels. Under these circumstances, it is difficult, though not impossible, to determine the normative basis of the role of corporate organisations in society; it is difficult to 'explain what companies should or should not do on behalf of the social good.'<sup>10</sup>

This section deals with the intricacies of corporate strategies to retain the legitimacy of their operations in society. It discusses this in relation to civil rights and the broader social responsibilities of business companies.<sup>11</sup> First, it highlights legitimacy and the precepts of legitimacy theory. Second, it discusses the interface between the classical view of business responsibilities and the need for corporate legitimacy in society, highlighting how corporate actions have been depoliticised and why they should be situated within the political framework from the perspective of their social responsibilities. Third, it focuses on the gradual development of the nexus between the demand for corporate legitimacy and corporate approaches to fulfilling this demand. Finally, it concludes that to retain their legitimacy in society, companies should accept the principles of CSR at their moral level, and their strategies for social responsibility should be situated within the framework of

---

<sup>5</sup> Belal, Above n 1, 14.

<sup>6</sup> Craig Deegan, Michaela Rankin and Voght P, 'Firms' Disclosure Reactions to Major Social Incidents: Australian Evidence' (2000) 24(1) *Accounting Forum* in Belal, above n 1, 14.

<sup>7</sup> Rob Gray, Dave Owen and Adams Carol, *Accounting and Accountability: Changes and Challenges in Corporate Social and Environmental Reporting* (1996) 46.

<sup>8</sup> Mark Mathews, *Socially Responsible Accounting* (1993) 26.

<sup>9</sup> Mark Suchman, 'Managing Legitimacy: Strategic and Institutional Approaches' (1995) *Academy of Management Review* 571.

<sup>10</sup> Swanson, above n 3.

<sup>11</sup> Matten, above n 4; J. Van Oosterhout, 'Corporate Citizenship: An Idea Whose Time Has Not Yet Come' (2005) 30(4) *Academy of Management Review* 677.

deliberative democracy in order for them to accept targeted public disclosures<sup>12</sup> or controlling by, or collaborating with, other parties who are considered legitimate.<sup>13</sup> This will be facilitated if they consider their social responsibility performance as central to their development policies.

### 3.2.1 *Legitimacy and CSR to Society*

The discourse of CSR builds on the concept of organisational legitimacy.<sup>14</sup> The arguments based on legitimacy for the development of CSR can be traced back to the precepts of legitimacy theory. Although this theory is more usually associated with politics, it has an organisational context. According to this theory, organisations exist within society under an implied or expressed social agreement. Scholars such as Thomas Hobbes, John Locke and Jean-Jacques Rousseau have related the intricacies of these agreements to the political theory 'insofar as it explained the supposed relationship between a government and its constituencies'.<sup>15</sup> Even in the changes of the medieval concept of the social contract, the notion of social agreement for organisational legitimacy remains virtually unchanged. In the modern era, the interpretation and development of arguments related to organisational legitimacy in society by scholars including John Rawls, Thomas Donaldson, John Dowling, Jeffrey Pfeffer, Mark Suchman and others are also based on the notion of this agreement.<sup>16</sup> The core of this agreement is that business organisations exist within a superordinate social system.<sup>17</sup> In this system, organisations enjoy legitimacy in so far as their activities are congruent with the broad objectives of this system.<sup>18</sup> From this perspective, J G Maurer describes corporate legitimacy in society in terms of the justification of

<sup>12</sup> It is also referred to as the process of communication.

<sup>13</sup> Craig Deegan, Michaela Rankin and John Tobin, 'An Examination of the Corporate Social and Environmental Disclosures of BHP from 1983 to 1997: A Test of Legitimacy Theory' (2002) 15 (3) *Accounting, Auditing and Accountability Journal* 312.

<sup>14</sup> Gray, Kough and Lavers, above n 1; Campbell, below n 15, 82.

<sup>15</sup> David J Campbell, 'Legitimacy Theory or Managerial Reality Construction? Corporate Social Disclosure in Marks and Spencer Plc Corporate Reports, 1969–1997' (2000) 24(1) *Accounting Forum* 80, 82.

<sup>16</sup> For the ideas of these scholars, see John Rawls, *A Theory of Justice* (Revised Edition Ed, 1999); John Dowling and Jeffrey Pfeffer, 'Organisational Legitimacy: Social Values and Organisational Behaviour' (1975) *Pacific Sociological Review* 122; Thomas Donaldson and Thomas Dunfee, *Ties That Bind: A Social Contracts Approach to Business Ethics* (1999); Amartya Sen, *The Idea of Justice* (2009); Suchman, above n 9.

<sup>17</sup> Dowling and Pfeffer, above n 16 in Campbell, above n 15, 83.

<sup>18</sup> Campbell, above n 15, 83.

certain corporate behaviours.<sup>19</sup> Suchman describes it from a different angle; he considers this legitimacy in terms of manipulation and engineering societal support.<sup>20</sup>

Cristi Lindblom defines the term 'legitimacy' as 'a condition or status which exists when an entity's value system is congruent with the value system of the larger social system of which the entity is a part.'<sup>21</sup> In legitimacy theory, the term 'legitimacy' also postulates that business organisations employ different strategies to ensure that their operations are considered legitimate by outside parties. It requires them to have adequate strategies in response to, for example, major environmental damage, major accidents leading to social crises or financial scandals created by their activities.<sup>22</sup> In other words, this theory assesses the kind of authority executives possess and the manner in which this authority is used.<sup>23</sup> This study considers the precepts of this theory relating to the legitimacy of business organisations within the boundaries and norms of society.

Corporate legitimacy deals with the appropriate role of companies in society.<sup>24</sup> It also emphasises the means by which society and companies might reach agreement on the issue of CSR. Suchman defines this nexus as a 'generalised perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions.'<sup>25</sup> Given this, he proposes three types of organisational legitimacy: pragmatic, cognitive and moral.

From the corporate perspective, pragmatic legitimacy is related to a company's strategies to ascribe their legitimacy to their stakeholders and the wider public.<sup>26</sup> Through this approach, companies are challenged to influence an individual's assessment of the usefulness of its operations, structure and leadership behaviour in society.<sup>27</sup> To gain legitimacy in a pragmatic way, companies create strategies to provide direct benefits, for instance, management roles for their constituents. In most cases, this approach allows companies to gain legitimacy by strategic manipulation of the perceptions of their stakeholders.<sup>28</sup> Cognitive legitimacy operates

---

<sup>19</sup> John G Maurer, *Readings in Organisation Theory: Open-System Approaches* (1971) in Campbell, above n 15, 83.

<sup>20</sup> Suchman, above n 9, in Campbell, above n 15, 83.

<sup>21</sup> Cristi Lindblom, 'The Implications of Organisational Legitimacy for Corporate Social Performance Disclosure' (1994) 2.

<sup>22</sup> *Ibid.* 14.

<sup>23</sup> Richard C Warren, 'The Evolution of Business Legitimacy' (2003) 15(3) *European Business Review* 153, 156; Craig Deegan and Jeffrey Unerman, *Financial Accounting Theory* (2006) 253.

<sup>24</sup> Guido Palazzo and Andreas Georgscherer, 'Corporate Legitimacy as Deliberation: A Communicative Framework' (2006) 66(1) *Journal of Business Ethics* 71, 77.

<sup>25</sup> Suchman, above n 9, 574 in Palazzo and Scherer, above n 24, 77.

<sup>26</sup> Suchman, above n 9.

<sup>27</sup> Ashforth, B.E. and Gibbs, B.W., 'The Double-edge of Organizational Legitimation' (1990) *Organization Science* 177.

<sup>28</sup> Campbell, above n 15, 86.

mainly at the subconscious level within the company and its constituents in society. This form of legitimacy emerges at the company level when stakeholders consider that the company's output, procedures, structures and leadership behaviour are necessary and based on their assumptions. Therefore, it is difficult for companies to strategically manipulate the perception of legitimacy of their stakeholders.<sup>29</sup>

Moral legitimacy refers to the conscious moral judgment of society on corporate output, procedures and leadership behaviour.<sup>30</sup> This legitimacy approach provides companies with the scope to give reasons and justify their actions, practices and values. It requires that the company 'reflects a pro-social logic that differs fundamentally from narrow self-interest.'<sup>31</sup> This legitimacy approach is preferred by society, as it resists the self-interested manipulation of other legitimacy strategies and insists on purely pragmatic legitimacy strategies within companies. Companies achieve moral legitimacy through 'explicit public discussion', which can be achieved by vigorous participation in social dialogue. Therefore, as Suchman states, companies should be dedicated to convincing others by demonstrating their genuine commitment to social values and demands, and should not depend on strategies for manipulating and persuading social perception of corporate legitimacy. With this approach, an organisation is perceived as legitimate, if it pursues 'socially acceptable goals in a socially acceptable manner.'<sup>32</sup> The following discussion elaborates on these issues.

### 3.2.2 *Corporate Legitimacy in Society: The Interface*

From a classical standpoint, the main objective of corporate strategies is to maximise the interest of their stockholders. This view contends that the 'invisible hand doctrine'<sup>33</sup> creates the greatest good for the greatest number and therefore government need not intervene in the market. However, in reality, there are problems

---

<sup>29</sup> Christine Oliver, 'Strategic Responses to Institutional Processes' (1991) *Academy of Management Review* 145; Suchman, above n 9; Oliver argues that this type of legitimacy could also be manipulated but a minor degree and through an indirect way. For details, see Christine Oliver, 'Strategic Responses to Institutional Processes' (1991) *Academy of Management Review* 145.

<sup>30</sup> Campbell, above n 15, 87.

<sup>31</sup> Suchman, above n 9 in Campbell, above n 15, 87.

<sup>32</sup> Ashforth and Gibbs, above n 27.

<sup>33</sup> The 'invisible hand' is the term economists use to describe the self-regulating nature of the marketplace. the theory of the invisible hand states that if each consumer is allowed free choice of what to buy and each producer is allowed free choice of what to sell and how to produce it, the market will settle on a product distribution and prices that are beneficial to all members of a community, and hence to the community as a whole. For details, see Ingrid Hahne Rima, *Development of Economic Analysis* (6th Ed, 2001).

within markets due to externalities,<sup>34</sup> monopolies,<sup>35</sup> and moral hazards.<sup>36</sup> Theoretically, these problems may not be present, though there are de facto constraints on the ability of the classical business company to act in the interests of the greater community. From a socio-political perspective, the apolitical role of companies, based on the rhetoric that all members of society benefit from capitalist production, increases confusion on the surge of corporate power and its impact on society.

The arguments for a reconceptualisation of corporate objectives centre round the following question: 'For whose benefit and whose expense should the firm be managed?'<sup>37</sup> This question, indeed, puts the ever-increasing interest of companies to maximise their returns without considering the future of their communities under scrutiny. It goes against the classical corporate objective, which is intrinsically related to the depoliticisation of corporate roles in the society.

### Depoliticisation of Corporate Roles in Society

Societal change is closely related to the precepts of organisational legitimacy. With this change, the liberal idea of maintaining legitimacy in political institutions and processes also change. This can be traced back to social-political developments in the medieval period. After the development of freedom in medieval Europe, the notion of civil liberty emerged. Subsequently, the concept of citizenship took a more formal form within which individualism and economic liberty became the two dominant themes.

In the notion of citizenship in modern civilised society, 'individualism' is an essential theme; it is determined by the free will of the people and the rule of law. States derive the legitimacy for their legal rules and public policies from the reason and the will of their citizens<sup>38</sup> and limit their individual decisions and actions by politically legitimate actions to ensure the interest of all citizens. However, unlike the individual citizen, actions for economic gain are kept beyond the reach of immediate legitimate demand. The activities of private actors and companies as the economic extension of the private self are not required to go beyond legal requirements and roles for common decency.<sup>39</sup> Thus, the economic actors in society

---

<sup>34</sup> Externalities means that the impact of one person's actions on the wellbeing of a bystander.

<sup>35</sup> Some markets have only one seller, and this seller sets the price. Such a seller is called a monopoly.

<sup>36</sup> The phrase moral hazard refers to the risk, or 'hazard', of inappropriate or otherwise 'immoral' behaviour by the agent who is imperfectly monitored.

<sup>37</sup> Edward Freeman, *Stakeholder Theory of the Modern Company: Kantian Capitalism* (1993) in Constantina Bichta, *Corporate Social Responsibility: A Role in Government Policy and Regulation?* (2003) 18; for details, see R Edward Freeman, *Strategic Management: A Stakeholder Approach* (1984).

<sup>38</sup> Jurgen Habermas, *Between Facts and Norms: Contributions to a Discourse Theory of Law and Democracy* (1998).

<sup>39</sup> Milton Friedman, *Capitalism and Freedom* (1982).

have been depoliticised.<sup>40</sup> Economic theory on freedom of choice in the market sphere emphasises that 'legitimation in the market sphere is 'automatic' and that markets thus avoid the typical legitimisation problem of the state.'<sup>41</sup> In the liberal concept of political theory, legitimacy demands that companies remain subjective, rather than objective. Companies do not have an obligation to relate their economic reasoning to social policies and values, and are focused on maximising their profit within the framework of the basic moral and legal rules of society.<sup>42</sup> Their roles for the development of the legitimacy of their actions within society remain primarily at the cognitive level.

This depoliticisation of companies with respect to legitimacy issues has become more salient with the dynamics of globalisation. 'Globalisation does not only macerate the cultural background of the nation state, it furthermore leads to a vivid debate on the interplay of state, economy and civil society which in turn results in reconceptualisations of legitimacy in political theory.'<sup>43</sup> The impact of globalisation has boosted the private sector and in turn, this sector has become tremendously powerful in all respects. Accordingly, this has also raised the general expectation of wider society towards corporate society; these days, society considers companies as 'quasi-public' actors. However, the response from corporate bodies to these expectations has not matched social expectations; companies are frequently blamed for the misuse of their ability to influence social development and for their self-centred strategies.<sup>44</sup> Moreover, although the side effects of

---

<sup>40</sup> Georg Scherer and Gudino Palazzo, 'Toward a Political Conception of Corporate Responsibility: Business and Society Seen from a Habermasian Perspective' (2007) 32(4) *Academy of Management Review* 1096 in Palazzo and Scherer, above n 24, 13.

<sup>41</sup> Fabienne Peter, 'Choice, Consent, and the Legitimacy of Market Transactions' (2004) 20 (01) *Economics and Philosophy* 1.

<sup>42</sup> Theodore Levitt, 'The Dangers of Social Responsibility' (1958) 36(5) *Harvard Business Review* 41; Deepak Lal, 'Private Morality and Capitalism: Learning from the Past' in John Dunning (Ed), *Making Globalisation Good: The Moral Challenges of Global Capitalism* (2004) 41; 'The Good Company', *The Economist* 22 January 2005, 3–18; Robert Reich, 'The New Meaning of Corporate Social Responsibility' (1998) 40(2) *California Management Review* 8 in Palazzo and Scherer, above n 24, 86.

<sup>43</sup> Palazzo and Scherer, above n 24, 88. For details, see Ulrich Beck, *What is Globalisation?* (2000); Stephen J Kobrin, 'Sovereignty@ Bay: Globalisation, Multinational Company, and the international Political System' (2001) *Oxford Handbook of International Business* 181; Patrizia Nanz and Jens Steffek, 'Global Governance, Participation and the Public Sphere' (2004) 39 (2) *Government and Opposition* 314.

<sup>44</sup> Currently, large companies are keen to enter national and global economic, fiscal, social, cultural, environmental and political systems, with the objective of creating a favourable climate for transnational investment and competition in the new global economy. This intervention creates confrontation on issues of employment policy, equality, job security and national security within developing states. There are many examples to illustrate this point. For example, it is argued that the concerns expressed by former Chilean president Salvador Allende to the UN regarding the plans of the International Telegraph and Telephone Company (ITT) and the Kennecott Copper Corporation to overthrow his government was the main cause of his death in a military coup. For details, see Judith Richter, *Holding Corporations Accountable: Corporate Conduct, International Codes and*



corporate operations have been raised and in many instances go beyond the sphere of state control, corporate society's contribution to the mitigation of these side effects is meagre.<sup>45</sup> At this juncture, corporate activities that were originally considered politically neutral are now loaded with more and more public demands; their interface with civil liberty and social legitimacy is more important than that with the state authorities.

### Politicisation of Corporate Roles in Society

The classical view of the corporate role in the social development is constantly being challenged. Recently, this challenge has gained momentum. With the rise of corporate influence in politics, corporate operations being increasingly viewed as responsible for social and environmental damage, hence the necessity of corporate expertise to further development. Neo-liberal economic reasoning is related to these circumstances: on one hand, it assists the increase of international trade, in which corporate organisations hold a major stake; while on the other, it helps the development of arguments against the depoliticised role of companies in society. With the increase in the volume of international trade, the number of corporate initiatives at a national level to deal with issues such as human rights, labour standards, corruption and environmental protection has also increased. Again, with neo-liberal discourse emphasising deregulation and corporate rights, the number of large companies and their influence has increased following the acceptance of the 'open door' economy. However, compared to the increase in corporate ability, their role in social development has not improved.<sup>46</sup> Moreover, the contribution of

---

*Citizen Action* (2001); for a synopsis of this issue, visit the Corner House, 'Codes in Context TNC Regulation in an Era of Dialogues and Partnerships' (2002) at <http://www.thecornerhouse.org.uk/sites/thecornerhouse.org.uk/files/26codes.pdf> at 7 November 2011. In 1954, the United Fruit Company was a key actor in overthrowing Jacobo Arbenz' government in Guatemala, resulting in decades of violence in this country. For details, see Gustavo Gonzalez, 'Code of Conduct for TNCs Reappears' (2001) <http://www.twinside.org.sg/title/code-cn.htm> at 7 November 2011. People rioted and one person was killed when bechtel, a US-based water consortium, took over the water system of cochabama in Bolivia and almost immediately raised water prices. Feelings ran so high that the corporation's managers left the country and the service was returned to public ownership; Bechtel filed a legal suit against the Bolivian government for US \$25 million. For details, see Barry James, 'Challenges of Development for Corporate Responsibility', *International Herald Tribune* 19 August 2002, 5.

<sup>45</sup> The cost of damage to the environment by the business sector in 2008 estimated by London-based consultancy firm Trucost was worth US \$2.2 trillion—a figure bigger than the national economies of all but seven economies in the world that year. For a sector wise graph of this cost, visit <http://www.guardian.co.uk/environment/2010/feb/18/worlds-top-firms-environmental-damage> at 7 November 2011.

<sup>46</sup> Three billion people do not have access to clean water and basic sanitation and these causes about 5,000 children to die from water borne diseases every day. For details, see WHO, *World Water Day Report* (2002), available at [http://www.who.int/water\\_sanitation\\_health/takingcharge.html](http://www.who.int/water_sanitation_health/takingcharge.html) 7 November 2011. Greenhouse gas emissions are causing severe climate change and ecological imbalance; receding glaciers threaten low lying coastal cities with rising sea levels;

the larger companies to social development is meagre at best; they were originally designed to fulfil public purposes but have grown beyond their original mandate through the pursuit of economic growth and material progress.

'In contemporary societies, [corporate] economic power drives the circular loop of power/benefits.'<sup>47</sup> Large companies, with their economic power, can either contribute to or disrupt the circulation of this loop. In nations in which they contribute less to overall socio-economic life, the people of that nation benefit less from economic activities.<sup>48</sup> Hence, as mentioned above, 'an inward spiral of diminishing benefit could result in increased disillusionment and deterioration of legitimate support from society for the companies.'<sup>49</sup> Regarding this point, at the peak of the growth and influence of companies (and simultaneously during the failure of the paradigmatic dominance of instrumental rationality to check the continuing extension of socio-economic imbalances), the question of the rationality of the regulatory framework for companies comes to the forefront of the social agenda. Advocates for the legitimate role of companies in social development demand new regulations focusing on socio-environmental needs with extended corporate responsibilities.<sup>50</sup> They connect this question with the concept of the 'social contract', which holds that there is a 'social contract' between business companies and the society within which they operate.<sup>51</sup> This can be explained as follows:

The social contract would exist between companies (usually limited companies) and individual members of society. Society (as a collection of individuals) provides companies with their legal standing and attributes and the authority to own and use natural resources and to hire employees. Organisations draw on community resources and output both goods and services and waste products to the general environment. The organisation has no inherent rights to these benefits, and in order to allow their existence, society would expect the benefits to exceed the costs to society.<sup>52</sup>

---

for details, see J Floor Anthoni, 'Seafriends: Summary of Threats to the Environment' (2001) [www.seafriends.org.nz/issues/threats.htm](http://www.seafriends.org.nz/issues/threats.htm) at 7 November 2011.

<sup>47</sup> Andrew Fergus and Julie Rowney, 'Sustainable Development: Lost Meaning and Opportunity?' (2005) 60(1) *Journal of Business Ethics* 24.

<sup>48</sup> Ibid. The recent 'occupy wall street' movement in the USA is an appropriate example that illustrates the lack of public trust in corporate power, strategies and responsibility to the society in which they operate. The core tenet of this movement is that corporate power and position in society and politics is creating serious class conflicts (mostly economic) in society, and corporate society is liable for the misery of individual economic life in the USA. For details, visit <http://www.guardian.co.uk/world/occupy-wall-street> at 10 October 2011.

<sup>49</sup> Ibid; for details of the political support of companies in the society and their impact on the social life of mass people, see Willis Harman, 'The Great Legitimacy Challenge' (1975) 42(5) *Vital Speeches of the Day* 147 in Fergus and Rowney, above n 47, 17, 24.

<sup>50</sup> Paul Hawken, 'A Declaration of Sustainability' (1993) 54(61) *Unite Reader*; Harman, above n 49.

<sup>51</sup> Belal, above n 1, 15.

<sup>52</sup> Mark R Mathews, *Socially Responsible Accounting* (1993) 26 in Deegan, Rankin and Tobin, above n 13, 315.

The term 'social contract' reflects the expectations of a society, both explicit and implicit, concerning the manner in which a company should conduct its operations in that society.<sup>53</sup> Different legal requirements of societies form the explicit terms of the social contract, while community expectations constitute the implicit terms.<sup>54</sup> The legitimacy of a company may be threatened by breaching social customs and rules (e.g., the terms of a social contract) and by failing to conform to social norms and expectations.<sup>55</sup> These issues are sensitive, and inappropriate responses to them would detrimentally affect the status of companies in society. In such situations, society may revoke the company's 'contract' to continue its operations.<sup>56</sup> The withdrawal of social support can have serious implications for companies, as explained by Deegan et al.:

This might be evidenced through, for example, consumers reducing or eliminating the demand for the products of the business, factor suppliers eliminating the supply of labour and financial capital to the business, or constituents lobbying government for increased taxes, fines or laws to prohibit those actions which do not conform with the expectations of the community.<sup>57</sup>

International society has criticised the classical corporate objective and pressured corporate societies to guarantee more external control of corporate management in order to ensure corporate responsibility within the societies in which they operate. The most demanding voices joining this chorus against the corporate system have come from a perfectly respectable corner of global society: 'from the college campus, the pulpit, the media, the intellectual and literary journals, the arts and sciences and from politicians.'<sup>58</sup> With their criticism, certain rights over corporate management have been bestowed upon the groups with a stake in, or claim on, manufacturers.<sup>59</sup> This has been leveraged by some major shifts in the related doctrinal cohort. For example, the doctrine of 'privity of contract' as articulated in *Winterbottom v. Wright* (1842) 10 M&W 109 changed in the USA with the decision of *Greenman v. Yuba Power* (1963) 59 Cal.2d 57. Through the decision of the Greenman case, manufacturers bear strict liability for damage

<sup>53</sup> Richard C Warren, 'The Evolution of Business Legitimacy' (2003) 15(3) *European Business Review* 153, 156.

<sup>54</sup> Deegan argues that the terms of a social contract are difficult to determine and different organisations might have different perceptions of the terms. It is in relation to the implicit terms where managers' perceptions can vary to a great extent. For details, see Craig Deegan, Michaela Rankin and Peter Voght, 'Firms' Disclosure Reactions to Major Social Incidents: Australian Evidence' (2000) 24(1) *Accounting Forum* 101.

<sup>55</sup> Belal, above n 1, 15.

<sup>56</sup> Craig Deegan, 'The Legitimising Effect of Social and Environmental Disclosures—A Theoretical Foundation' (2002) 15(3) *Accounting, Auditing & Accountability Journal* 282, 292–293.

<sup>57</sup> Deegan, Rankin and Voght, above n 55.

<sup>58</sup> Comment of Lewis F. Powell, Jr is mentioned in <http://www.answers.com/topic/lewis-franklin-powell-jr> at 22 November 2010.

<sup>59</sup> For details on this point, see the discussion on the stakeholder approach to the corporate management at the later part of this chapter.

caused by their products, even though the seller has maintained all precautions and the buyer has no contractual agreement with the seller. Thus, the concept of *Caveat Emptor*<sup>60</sup> has been replaced with that of *Caveat Venditor*.<sup>61</sup> Institutionalised consumerism and regulations following this consumerism have also changed the classical mode of corporate management. International consensus and national frameworks for protecting labour and environmental rights have also emphasised this change. For instance, the recent legal regulations related to clean water and air have constrained companies from ‘spoiling the commons’. In *Marsh v. Alabama* (1946) 326 US 501, the US Supreme Court negated the ‘property rights’ of the company to uphold the right of local citizens.<sup>62</sup>

In this context, the business system has focused more on united actions.<sup>63</sup> From 1971 to 1979, the number of companies represented by registered lobbyists grew from 175 to 650 in USA; the National Association of Manufacturers was moved to Washington in 1973; while the chief executive officers of Fortune 500 companies formed the Business Roundtable in 1972. Their joint efforts raised the membership of the Chamber of Commerce from 36,000 in 1967 to 80,000 in 1974.<sup>64</sup> With this new approach, corporate societies have directed their power to the cultural and political fronts. For instance, corporate grants to the Public Broadcasting System increased from US \$3.3 million in 1973 to US \$22 million in 1979, and between 1974 and 1978 at least 40 ‘free company’ chairs were funded, primarily at liberal undergraduate colleges in the USA.<sup>65</sup> Gradually, these cultural initiatives became guided by political ends. As Gramsci, Lewis F Powell have noted:

...one should not postpone more direct political action, while awaiting the gradual change in public opinion to be effected through education and information. Business must learn the lesson, long ago learned by labour and other self-interested groups. This is the lesson that political power is necessary; that such power must be assiduously [sic] cultivated; and that

---

<sup>60</sup> This Latin term is for ‘let the buyer beware’. It is a property law doctrine that controls the liabilities of the seller of a real property. According to this doctrine, the buyer could not recover from the seller for defects on the property that render the property unfit for general use. For detail, visit [http://en.wikipedia.org/wiki/caveat\\_emptor](http://en.wikipedia.org/wiki/caveat_emptor) at 1 August 2011.

<sup>61</sup> Caveat venditor is the opposite of caveat emptor. This Latin term translates as ‘let the seller beware’. It suggests that sellers can also be deceived in a market transaction. This doctrine forces the seller to take responsibility for faulty products and discourages them from selling sub-standard products. For details, visit [http://en.wikipedia.org/wiki/caveat\\_venditor#caveat\\_venditor](http://en.wikipedia.org/wiki/caveat_venditor#caveat_venditor) at 1 August 2011.

<sup>62</sup> The facts of this case are as follows: a lady was distributing religious handbills standing beside the road in a town owned by a company. She was arrested on a charge of ‘trespassing’. The United States Supreme Court decided that the right to freedom cannot be denied simply to uphold property rights. For details, visit [http://en.wikipedia.org/wiki/marsh\\_v.\\_alabama](http://en.wikipedia.org/wiki/marsh_v._alabama) at 1 August 2011.

<sup>63</sup> Freeman, above n 37.

<sup>64</sup> Edsell Thomas Byrne, ‘Business in American Politics: Its Growing Power, Its Shifting Strategies’ (1990) Spring *Dissent* 248 in James K. Rowe, *Corporate Social Responsibility As Business Strategy* (2004) 131, available at <http://escholarship.org/uc/item/5dq43315jsessionid=f6bafa0de62a77972be9ffebe8157cee> at 3 December 2011.

<sup>65</sup> Ibid.

when necessary, it must be used aggressively and with determination—without embarrassment and without the reluctance which has been so characteristic of American business.<sup>66</sup>

Corporate societies' strategies to tackle societal pressure on legitimacy issues gained momentum when businesses successfully organised the Political Action Committee (PAC) in the USA as the steering body for implementing their programs in society. In 1974, there were 89 corporate PACs. This increased to 784 by 1978, and by the end of 1982, there were 1,467.<sup>67</sup> In response to their organised political efforts, labour-related PACs grew only from 201 to 380 between 1972 and 1982.<sup>68</sup> As Edsell lucidly points out:

The political wing of the nation's corporate sector staged one of the most remarkable campaigns in the pursuit of power in recent history. By the late 1970s and the early 1980s, business, and Washington's corporate lobbying community in particular, had gained a level of influence and leverage approaching that of the boom days of the 1920s.<sup>69</sup>

Corporate society began dealing with 'social legitimacy' issues pragmatically; from the cognitive level, companies gradually shifted legitimacy issues to the pragmatic level. Although the contradicting arguments and practices related to corporate roles and strategies for social responsibility have been prominent in the discussion of CSR, this momentum has made corporate society more relaxed and strategic in response to demands for social responsibility. They have stepped back from their economic value creation-centred arguments based on their depoliticised status and became defensive. With the changed social circumstances they have initiated a plan of action of 'counterbalancing the use of intergovernmental codes as political levers while also creating a better understanding of corporate operations that could preclude more restrictive actions in the future.'<sup>70</sup> Their plans of action are designed to make them a self-consciously political force. They have focused more on efforts to legitimise their activities and began engaging in CSR practices in order to obtain social approval in support of their continued existence and 'license to operate'. Previously, companies were accustomed to seeking this legitimacy through philanthropy. However, with the institutionalisation of CSR practices, corporate engagement in society is more attached to specific circumstances and needs when dealing with social legitimacy and responsibility issues.

The conception that '200 years worth of work in economics and finance indicate that social welfare is maximised when all firms in an economy maximise total firm value'<sup>71</sup> is not as prominent as it was in the 1970s and argument has created doubt

<sup>66</sup> Lewis F. Powell Jr., 'Attack on the Free Company System' (2004), available at <http://www.mediatransparency.org/stories/powellmanifesto.htm> at February 2004 cited in Rowe, above n 65.

<sup>67</sup> Byrne, above n 65, 131.

<sup>68</sup> Edsell Thomas Byrne, *The New Politics of Inequality* (1984) 107.

<sup>69</sup> Ibid.

<sup>70</sup> John Kline, *International Codes and Multinational Business: Setting Guidelines for International Business Operations*, London: Quorum Books, 161 in Rowe, above n 65, 129.

<sup>71</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2002) *Business Ethics Quarterly* 235, 239.

that this capitalist rhetoric relates to the objectives of organisational legitimacy. The advocates for the extension of corporate roles in social development doubt the benefits of a pragmatic approach by companies to gain social legitimacy. As discussed earlier, this approach for creating legitimacy depends upon the strategic posture of individual companies; a company plans for this as long as it is required by the company. Therefore, in this approach, the objective of legitimacy strategies is limited to the narrow interests of the company and barely provides room for a genuine ethico-political interpretation of corporate behaviour. Moreover, with this approach, companies do not gain the insight needed to influence them to accept any additional social responsibility beyond that required by the law and their economic interests in order to claim legitimacy. As discussed earlier, civil groups, NGOs and the political system in general do not rely upon pragmatic legitimacy that 'refers either to a weak idea of a company's cognitive compliance or to the pragmatic legitimacy provided by capitalist rhetoric.'<sup>72</sup> Moreover, they have accused the corporate sector of not adequately contributing to the redressment of major socio-environmental problems. For instance, they claim that corporate society is directly or indirectly liable for the greenhouse gas emissions that are causing severe climate change and ecological imbalance; receding glaciers threaten low-lying coastal cities with rising sea levels.<sup>73</sup> The 2001 CSR monitor, based on 20,978 interviews with average citizens across the world found that more than 75 % of the participants felt that large companies should be 'completely responsible' for protecting the health and safety of workers and protecting the environment; that corporate beneficiaries owe an enormous ecological debt, particularly to the South, which must be redressed; and that governments should reassert their authority and responsibility over corporate powers.<sup>74</sup> This has helped civil groups put pressure on companies to shift the depoliticised status of companies towards their politicisation.

Political theory has identified companies as political since they provoke, and have the ability to provoke, 'public concern resulting from power.'<sup>75</sup> Their growing public influence on national sovereignty and democratic governance demands that scholars create suitable processes to provide rights and liabilities within the democratic order. The purpose of the politicisation of companies is to redefine their place

---

<sup>72</sup> Palazzo and Scherer, above n 24, 86.

<sup>73</sup> Corporate organisations, especially the transnational companies are capable of contributing to the redressment of social and environmental problems to the same extent as the nation states. Of the 15 companies and governments with the world's largest budgets, six are governments, nine are companies. Each of the 15 largest transnational companies now has a budget that exceeds the GDP of more than 120 nation states. Of the 100 largest economies, 51 are now transnational companies and 49 are nation states, with 90 % of these transnational companies being based in the 49 nation states. For details, visit <http://www.wcc-coe.org/wcc/what/jpc/corp-account.pdf> at 10 October 2011.

<sup>74</sup> For details, visit [http://www.globescan.com/news\\_archives/csr\\_exec\\_brief.pdf](http://www.globescan.com/news_archives/csr_exec_brief.pdf) at 10 October 2011.

<sup>75</sup> Neil Mitchell, 'Corporate Power, Legitimacy, and Social Policy' (1986) *Western Political Quarterly* 197,208; Max Weber, 'Economy and Society' (1968) 213; Jens Steffek, 'The Legitimation of International Governance: A Discourse Approach' (2003) 9(2) *European Journal of International Relations* 249.

in the society and their role in democratic accountability.<sup>76</sup> 'The call for discourse and communicative ethics in the broad field of corporate responsibility studies denotes a politicisation of the company since it opens corporate decision-making to civil society discourses.'<sup>77</sup>

The core of this politicisation would be the development of moral legitimacy in companies. While their cognitive legitimacy is eroding and their pragmatic legitimacy provokes growing resistance, moral legitimacy could help companies to genuinely address their social responsibilities.<sup>78</sup> Moral legitimacy is the key source of social acceptance and provides less scope for companies to engineer and manipulate the strategies required for managing the legitimacy pressures acting on them.<sup>79</sup> Even Friedman concludes that companies should conform 'to the basic rules of the society, both that embodied in law and those embodied in ethical custom.'<sup>80</sup>

### 3.2.3 *Corporate Legitimacy in Society: The Nexus*

Jesper Grolin offers an interesting account of three challenging models of corporate legitimacy.<sup>81</sup> Friedman's approach to corporate legitimacy, which focuses on the economic functions of companies, could be taken as the classical model of corporate legitimacy.<sup>82</sup> The second model is the stakeholder approach to gaining corporate legitimacy in society. This model details companies' responsibilities to those

---

<sup>76</sup> James P Walsh, Klaus Weber and Joshua D Margolis, 'Social issues and Management: Our Lost Cause Found' (2003) 29(6) *Journal of Management* 859.

<sup>77</sup> Palazzo and Scherer, above n 24, 91; for details, see Suchman, above n 9; Andrew Wicks and Edward Freeman, 'Organisation Studies and the New Pragmatism: Positivism, Anti-Positivism, and the Search for Ethics' (1998) *Organization Science* 123; Daniel Swanson, 'Toward an Integrative Theory of Business and Society: A Research Strategy for Corporate Social Performance' (1999) 24(3) *Academy of Management Review* 506.

<sup>78</sup> Palan shows how these two types of approaches for corporate legitimacy in society have been eroded. The unethical accounting in big companies, inadequate investment at the company level to minimise carbon emissions amid other issues has made previously accepted business behaviour the subject of critical public debate. For details, see Ronen Palan, *The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires* (2006) in Palazzo and Scherer, above n 24, 91.

<sup>79</sup> Blake Ashforth and Barrie Gibbs, 'The Double-Edge of Organisational Legitimation' (1990) *Organization Science* 177, 181.

<sup>80</sup> Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' (2007) *Corporate Ethics and Corporate Governance* 173,218; in the same fashion, Epstein and Votaw concludes that companies have to act according to the moral foundation of the society. For details, see Edwin Epstein and Dow Votaw, *Rationality, Legitimacy, Responsibility: Search for New Directions in Business and Society* (1978) 3.

<sup>81</sup> Grolin, below n 90; John Dryzek, 'Transnational Democracy' (1999) 7(1) *Journal of Political Philosophy* 30, 35.

<sup>82</sup> Friedman, above n 81; James Guthrie and Parker L D, 'Corporate Social Reporting: A Rebuttal of Legitimacy Theory' (1989) 19(7) *Accounting and Business Research*.



affected by business decisions and operations in a tangible way. The third model is the political company model. It reflects the ethos of the globalisation of the economy and a parallel weakening of national government authority. Its scope is greater than that of the other two models, and it touches the transnational context of this issue by advocating that:

...a company should adopt a clear set of moral and ethical values, which relate to the general public both globally and locally, and which can guide corporate actions irrespective of whether [the company] is explicitly required by law.<sup>83</sup>

Grolin's arguments on the political company model are closely related to the Brent Spar conflict.<sup>84</sup> On the knowledge gained from this conflict, Grolin argues that companies should reach out to the general public to acquire legitimacy for their operations. During this conflict, although Shell was experiencing a consumer boycott across the northern economies, it took time to dispose of its oil storage platform, as it was unable to solve certain engineering problems. The British government helped Shell to solve these problems, and hence Shell was dependent on the government and its allied political institutions. However, Shell had to face the conflict with the public, and as a result of public pressure, it had to step back. Thus, this conflict relates to the 'clash between the reductionist rationality of the scientific expert and the common-sense rationality of the lay public.'<sup>85</sup> It also marks a change 'in the location of the driving forces of politics from formal political institutions to groups and individuals of civil society.'<sup>86</sup> Based on the inability of political institutions to establish the legitimacy of organisational activity, in the future, companies are likely to be held accountable by the public for their legitimate activities.<sup>87</sup>

Following the concept of corporate legitimacy through CSR practices, international societies, consumers, and transnational companies develop different frameworks to ensure greater legitimacy in the companies within their societies. Most of the principles of these frameworks are meant to provide guidance (i.e., in the development of moral responsibility for ensuring good CG) and assist national governments to assess and develop CG. Moreover, scholars have become interested in applying moral responsibility to organisations as they do to individuals. Goodpaster and Matthews argue in this direction, asserting that companies should

---

<sup>83</sup> Ibid.

<sup>84</sup> Brent Spar is an oil storage platform in the North-East Atlantic. Regarding its dumping, shell and greenpeace had conflicts started in 1995. Based on theories of corporate legitimacy and risk society, this conflict raised an argument that created a demand for a new balance between business, government and civil society as well as a radicalisation of the requirements for corporate legitimacy. For more details, see Jesper Grolin, *Corporate Legitimacy in Risk Society—the Case of Brent Spar*, Business Strategy and the Environment (1998), available at <http://www3.interscience.wiley.com/journal/61003263/abstract?cretry=1&srtry=0> at 14 November 2011.

<sup>85</sup> Grolin, above, in Bichta, above n 37, 22.

<sup>86</sup> Ibid.

<sup>87</sup> Bichta, above n 37, 22.



base their corporate conscience on the morals individuals hold, and that business strategies should follow the efforts of individuals to hold moral attitudes.<sup>88</sup>

In order to establish moral responsibility in companies, Goodpaster and Mathews have analysed individual moral responsibility and relate this to organisational behaviour. According to them, individual decision-making (or moral responsibility) is based on rationality, and it extends its values to others' rationalities. They further argue that this responsibility involves 'careful mapping of alternatives, clarity about goals and purposes, attention to details of implementation...and concern for the effects of an individual's decisions and policies on others.'<sup>89</sup> Business society is gradually accepting this argument, and accordingly, shows almost the same kind of rationality and values that individuals hold while making decisions. Companies have developed 'features into their management incentive systems, board structures, internal control systems, and research agendas that in a person we would call self-control, integrity, and conscientiousness.'<sup>90</sup> They also consider the human impact of their operations and strategies; they usually do not make controversial policies.<sup>91</sup> For instance, companies tend to rely on management-based strategies rather than strategies based on the concept of the 'invisible hand' and government intervention to explain their moral behaviour.<sup>92</sup> This is because they aim to create an internal source for their behaviour rather than be guided by any external system. Like individuals, companies have their own sets of values. Thus, the ethos of individual behaviour and responsibility has scope to shape corporate conscience; the moral responsibility that exists among individuals could be the source of the socially responsible corporate behaviour that is a vital component of acquiring legitimacy of business operations in society.<sup>93</sup>

Companies incorporate CSR practices to gain social legitimacy. Their interest in CSR practices has increased, as evidenced by the increasing numbers of companies joining the existing cohort of CSR reporters.<sup>94</sup> The precepts of legitimacy theory help to secure their commercial interest through building a strong relationship with their customers.<sup>95</sup> By adopting and implementing CSR practices, they can improve customer satisfaction, which translates into better business, while increasing employee satisfaction results in the delivery of a better quality service and greater

---

<sup>88</sup> Kenneth E. Goodpaster and Jr. John B. Mathews, 'Can A Corporation Have A Conscience?' (1982) 60(1) *Harvard Business Review* 132 in Bichta, above n 37, 21.

<sup>89</sup> Ibid.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid 132, 136.

<sup>92</sup> Ibid 132.

<sup>93</sup> Ibid.

<sup>94</sup> For example, 80 % of ftse-100 companies now provide information about their environmental performance and social impact. For details, see Deegan and Rankin, above n 87; for more information, visit [http://www.article13.com/a13\\_contentlist.asp?straction=getpublication&pnid=569](http://www.article13.com/a13_contentlist.asp?straction=getpublication&pnid=569) at 15 April 2009.

<sup>95</sup> D. Neu, H. Warsame and K. Pedwell, 'Managing Public Impressions: Environmental Disclosures in Annual Reports' (1998) 23(3) *Accounting, organizations and Society* 265.

business success. With CSR practices, companies can gain social legitimacy and, at the same time, minimise the threat and cost for litigation and NGO action that could have a detrimental effect on their reputation and overall business performance. Moreover, they can use their legitimacy to create a competitive advantage by raising barriers to entry in the market. For example, Wal-Mart relies heavily on advertising the CSR activities that its stores carry out in the local communities where they operate. The Body Shop's reputation was built on the ethical sourcing of its products.

A shift towards improving corporate moral legitimacy would help companies implement CSR principles as an integral part of their business plans. This approach would allow companies to move from economic, utility-driven, and output-oriented strategies to political, input-oriented and communication-driven strategies for fulfilling their social responsibility. Appropriate political strategies would allow for the development of 'the link between corporate decision-making and process of will-formation in a company's stakeholder network.'<sup>96</sup> Strategies for a communicative approach could include the exchange of value-based information between a company and its social environment.<sup>97</sup> For the development of this approach, particularly in the weak economies, Guido Palazzo and Andreas Scherer propose embedded organisational legitimacy, with the central aim being to link the legitimacy and social responsibility issues of companies to a deliberative democracy framework through communication-based strategies.<sup>98</sup> This strategy acknowledges the role of public and private actors in addressing the consequences of problematic market behaviour. The communicative power of companies is used in this strategy 'in the manner of a siege...without intending to counter the system itself.' A company, therefore, must be open to critical deliberation in principle as well as to assume its actions for gaining social acceptance since 'issues of legitimacy does not arise unless an order is contested.'<sup>99</sup>

To summarise, 'legitimacy' is critical to companies seeking to secure a continued supply of key resources,<sup>100</sup> and they must retain their legitimacy to retain their license to operate within society. Moreover, in order to conform to the changing perceptions of society, they must adapt and change their strategies and,

---

<sup>96</sup> Palazzo and Scherer, above n 24, 93; for details, see Andrew Wicks and Edward Freeman, 'Organisation Studies and the New Pragmatism: Positivism, Anti-positivism, and the Search for Ethics' (1998) *Organization Science* 123; Iris Young, 'From Guilt to Solidarity' (2003) 50 (2) *Dissent* 39.

<sup>97</sup> Palazzo and Scherer, above n 24, 93; Carlton and Payne defines this strategy as 'an interactive field of discourse'. For details, see Jerry Calton and Steven Payne, 'Coping With Paradox' (2003) 42(1) *Business & Society* 7; Timothy Kuhn and Karen Lee Ashcraft, 'Corporate Scandal and the Theory of the Firm' (2003) 17(1) *Management Communication Quarterly* 20.

<sup>98</sup> Palazzo and Scherer, above n 24, 93.

<sup>99</sup> Bosire Maragia, 'Almost There: Another Way of Conceptualising and Explaining NGOs' Quest for Legitimacy in Global Politics' (2002) 2(3) *Non-State Actors and International Law* 301, 312.

<sup>100</sup> John Dowling and Jeffery Pfeffer, 'Organisation Legitimacy: Social Values and Organisational Behaviour' (1975) 18(1) *Pacific Sociological Review* 122.

more importantly, communicate these changes to their stakeholders. With the changes in the landscape of their social, corporate and political environments, the cognitive and pragmatic approaches that companies have previously employed to fulfil their social responsibilities are no longer sufficient for protecting the ethos of their contract with society. Increasingly, these changes in the socio-political framework are being accompanied by arguments calling for these approaches to be complemented with moral approaches for social legitimacy.<sup>101</sup>

### 3.3 CSR Through Legal Regulation: ‘Stakeholder’ Argument

The framework by which organisations are governed has changed.<sup>102</sup> This change comes through changes in industrial structures and shifts in economic relationships and the broader dimension in the business–society interface where the force of community compels political powers and business society to review the ways in which companies are governed. Stakeholder theory has gradually put this change at the centre of research into business and society relations. The works of Edward Freeman make this theory an internationally dominant paradigm. He set forth the reconceptualisation of the notion of corporate management in the form of this theory, which has spurred the theoretical as well as the strategic approaches of corporate management.<sup>103</sup>

The meanings of ‘stake’ and ‘holder’ are important within stakeholder theory. Simply stated, the word ‘stake’ means a right to do something in response to any act or attachment. Since ‘rights’ are generally associated with liabilities, this word also denotes the liabilities a person possesses for enjoying a particular right. Hence, a stake could be a legal share of something. It could be, for instance, a financial involvement with something. From the organisational stakeholder perspective, Carroll identifies three sources of stakes: ownership at one extreme, interest in between, and legal and moral rights at the other extreme.<sup>104</sup> The word ‘holder’ is comparatively easy to understand. It denotes a person or entity that faces certain consequences or a need to do something because of an act or to meet a certain need.

---

<sup>101</sup> Georg Scherer and Gudio Palazzo, ‘Toward A Political Conception of Corporate Responsibility: Business and Society Seen from A Habermasian Perspective’ (2007) 32(4) *Academy of Management Review* 1096.

<sup>102</sup> For an earlier version of this section, see Mia Mahmudur Rahim, ‘The Stakeholder Approach to Corporate Governance and Regulation: An Assessment’ (2011) 8 *Macquarie Journal of Business Law* 304–325.

<sup>103</sup> Tom Cannon, *Corporate Responsibility- A Textbook on Business Ethics, Governance, Environment, Role and Responsibilities* (1994).

<sup>104</sup> Archie B Carroll and Ann K Buchholtz, *Business and Society: Ethics and Stakeholder Management* (2008) 58 in Eeva Siljala, *Development of Corporate Social Responsibility in Finnish Forest Industry* (Masters Book, Lappeenranta University of Technology, 2009) 23.

From the organisation and management perspective, Freeman defines stakeholder as ‘any group or individual who can affect or is affected by the achievement of the firm’s objectives.’<sup>105</sup> Archie Carroll defines a stakeholder from a broader perspective, as he determines stakeholders to be ‘any individuals or groups who can affect or are affected by the actions, decisions, policies, practices or goals of an organisation.’<sup>106</sup> Thus, employees, customers, owners, competitors, government and civil organisations could be the stakeholders of a company. Gray and colleagues even extend this list to include future generations and non-human life.<sup>107</sup>

Within business and society relations, the core idea of stakeholder theory is that CG has the responsibility (i.e., the stakeholder has rights) to consider the views of their stakeholders in corporate self-regulation. Hence, this concept challenges the central position of managerial capitalism. Two arguments could have prompted this challenge. The first of these considers that today’s companies are no longer fit for the old model of governance. It argues that the concept of ownership has shifted from its hard strand, and hence, companies can no longer accurately be viewed by their owners as private property.<sup>108</sup> The second argument develops around the power relationship between business and society. It claims that social power comes with social responsibility, and hence, failing to mitigate the costs that arise (i.e., out of industrial pollution, hazardous products, job dissatisfaction, etc.) inevitably raises questions about the exercise and limitation of corporate power.<sup>109</sup>

Taking these arguments as vital to this theory, it focuses on a particular question: ‘For whose benefit, and at whose expense, should the firm be managed?’<sup>110</sup> In reply, the initiators of this theory define stakeholders as all the parties that have vested interests in, or are claimant on, the company, including proprietors, management, suppliers, customers, employees, and the local community.<sup>111</sup> They argue, in accordance with Kantian philosophy, that none of these stakeholders can be treated as a means to some end, and they have the obligatory right to participate in determining the future direction of the businesses in which they have a stake.<sup>112</sup> They challenge the opinion that business organisations have no absolute right to decide on how things should be settled for their constituents by

---

<sup>105</sup> Freeman, above n 37, 46.

<sup>106</sup> Carroll and Buchholtz, above n 105.

<sup>107</sup> Gray, Owen and Carol, above n 7, 45 in Siljala, above n 105, 24; for more details on the classification of stakeholders, see Archie B Carroll and Ann K Buchholtz, *Business and Society: Ethics and Stakeholder Management* (2008) 58; Ming-Dong Poul Lee, ‘A Review of the Theories of Corporate Social Responsibility: Its Evolutionary Path and the Road Ahead’ (2008) 10(1) *International Journal of Management Reviews* 53, 61.

<sup>108</sup> Michael Hoffman and Robert Frederick, *Business Ethics—Readings and Cases in Corporate Morality* (3rd Ed, 1995).

<sup>109</sup> Ibid.

<sup>110</sup> William Evan and Edward Freeman, *A stakeholder theory of the modern corporation: Kantian Capitalism* (1993).

<sup>111</sup> Ibid.

<sup>112</sup> Ibid 148.

positing that 'if the modern company requires treating others as means to an end, then these others must agree on, and hence participate (or chose not to participate) in, the decisions to be used as such.'<sup>113</sup> Reasonably, this theory has noted that the rights to property, though legitimate, are not absolute, specifically when it comes to conflict with the rights of others. It was further advocated that 'the property rights are not a license to ignore Kant's principle of respect for a person.'<sup>114</sup> Another dominant theme of this theory deals with the impact of managerial capitalism and the manner in which the precept of 'modern company' affects the welfare of others. In terms of corporate externalities and harmful actions, this theory extends the liabilities for these actions to the persons responsible for the corporate decisions and activities. Hence, any theory that seeks to justify the corporate form 'must be based at least partially on the idea that the company and its managers as moral agents can be the cause of and can be held accountable for their actions.'<sup>115</sup>

Indeed, the justification for the normative basis of this theory is based on the evolving arguments regarding the concepts of property rights,<sup>116</sup> though there is no single set of norms that describes the term 'property'. 'Property' and 'bundle of many rights' are defined synonymously. However, property resembles the right with recurrent features. Ronald Coase subscribed to the view that 'what a land-owner in fact possesses is the right to carry out a circumscribed list of actions. . .and his rights as a land-owner are not unlimited.'<sup>117</sup> Authors such as Honore and Pejovich have extended Coase's notion of property rights and underscored the link between property and human rights by noting that 'the right of ownership is not an unrestricted right.'<sup>118</sup> Another oft-quoted opinion relevant to the right of property is that it is a core human rights issue, emphasising its rational use. This opinion is also intrinsic to the concept of property rights and clearly signals the engagement of stockholders in the conception of the property rights of business organisations. Within the academic community, this opinion creates contention over the notion of property rights. On one hand, it is contended that simply bringing non-owner stakeholders into the conception of property rights does not provide justification for stakeholders' arguments assigning managerial responsibilities toward specific groups (i.e., employees, customers). On the other hand, the contemporary theoretical concept of property rights does not ascribe unlimited rights to owners or shareowners.

---

<sup>113</sup> Ibid.

<sup>114</sup> Bichta, above n 37.

<sup>115</sup> Hoffman and Frederick, above n 109, 148.

<sup>116</sup> Thomas Donaldson and Preston L E, 'The Stakeholder Theory of the Company-Concepts, Evidence and Implications' (1995) 20 *Academy of Management Review* 65.

<sup>117</sup> Ronald Coase, 'The Problem of Social Cost' (1960) 3(October) *Journal of Law and Economics* 1.44.

<sup>118</sup> For more information on contemporary arguments of property rights look at Anthony M Honoré, *Ownership*, Oxford Essays in Jurisprudence (1961); Svetozar Pejovich, *The Economics of Property Rights—Towards A Theory of Comparative Systems* (1990).

Stakeholder theory has allowed the convergence of these contradictory arguments. To be attached to the right of property that is created and maintained by companies, this theory aligns two principles: the principle of corporate rights and the principle of corporate effects. According to the principle of corporate rights, corporate managers who are liable for framing core corporate decisions cannot violate the legitimate rights of a company's constituents for their personal benefit. The principle of corporate effects denotes that corporate managers and companies as separate entities are equally responsible for the effects of their actions on others. These two principles are the source of a further two principles for managing the stakeholders of business companies. The principle of 'corporate legitimacy' focuses on the rights and responsibilities of companies and their effects on others, while the 'stakeholder fiduciary principle' drives the managerial strategies for addressing the demands of shareholders. These principles, in fact, contribute to creating structural mechanisms to facilitate the application of the concept of stakeholder management. This management concept provides scope to revise and reform corporate law so that the companies can be managed for the benefit of their stakeholders, and allows stakeholders to participate in the company decision-making processes that affect their welfare.

### ***3.3.1 A Stakeholder Approach for Regulation CSR in Companies***

To ensure the best possible fit with the various dimensions of corporate management, the pioneers of stakeholder theory have developed three main operational approaches: normative, instrumental and descriptive/empirical.<sup>119</sup> The normative approach defines the manner in which management deals with different stakeholders.<sup>120</sup> The instrumental approach describes the outcomes of managerial treatment of stakeholders. The descriptive approach is concerned with the stakeholder management activities of companies.<sup>121</sup> This approach is used to describe and explain specific corporate characteristics and behaviours. The instrumental approach to stakeholder theory is used to identify the connections between stakeholder management and the achievement of traditional corporate objectives such as profitability and growth. The normative approach to stakeholder theory is used to

---

<sup>119</sup> For details, see Donaldson and Preston, above n 117.

<sup>120</sup> For details, see Edward Freeman, *Business Ethics—Readings and Cases in Corporate Morality* in Michael Hoffman, Robert Frederick, Schwartz (2001 4th Ed); Jerry I Porras and Jim Collins, *Built to Last: Successful Habits of Visionary Companies* (1994); Lynn Sharp Paine, 'Managing for Organisational Integrity' (1994) 72 *Harvard Business Review* 106.

<sup>121</sup> Shawn Berman et al., 'Does Stakeholder Orientation Matter? The Relationship Between Stakeholder Management Models and Firm Financial Performance' (1999) 40(5) *Academy of Management Journal* 488,199; Belal, above n 1, 18.

interpret the function of the company. From these perspectives, the relevance of this theory to corporate management can be summarised as follows<sup>122</sup>:

1. Companies have relationships with many constituent groups (stakeholders) that affect and are affected by their decisions.
2. It is important for companies to be concerned with the nature of these relationships in terms of both processes and outcomes for themselves and their stakeholders.
3. The interests of all legitimate stakeholders have intrinsic value, and no set of interests can be assumed to dominate the others.
4. A focus on managerial decision-making is vital to the company-stakeholder relationship.

Based on research findings on the above-mentioned tenets, Berman and colleagues have suggested two distinct stakeholder approaches that amplify the causal relationship between groups of stakeholders and a company.<sup>123</sup> The first of these, the strategic stakeholder management approach, suggests that companies are interested in stakeholders because they are part of the corporate constituents and consumers and hence necessary for developing financial performance. The second approach, intrinsic stakeholder commitment, suggests that 'managerial relationships with stakeholders are based on normative, moral commitments rather than on a desire to use those stakeholders solely to maximise profits.'<sup>124</sup> Freeman's definition of stakeholders stated earlier also suggests a two-way relationship between companies and their stakeholders.<sup>125</sup> The first element, whereby stakeholders can affect companies, relates to the strategic stakeholder management approach suggested by Berman et al., and the second element, whereby stakeholders are affected by companies' activities, relates to intrinsic stakeholder commitment.<sup>126</sup>

Focusing more on the strategic relationship between stakeholders and companies when considering their social responsibilities, Arie Ullmann suggested a three-dimensional conceptual approach of stakeholders towards business operations in

---

<sup>122</sup> Thomas Jones and Andrew Wicks, 'Convergent Stakeholder Theory' (1999) 24(2) *Academy of Management Review* 206,207; for a detailed discussion on this approach, see Belal, above n 1, 18.

<sup>123</sup> Berman et al., above n 122.

<sup>124</sup> Ibid 492; for a detailed discussion on this view of Freeman, see Ataur Rahman Belal, 'Stakeholder Accountability or Stakeholder Management: A Review of UK Firms' Social and Ethical Accounting, Auditing and Reporting (SEAR) Practices' (2002) 9(1) *Corporate Social Responsibility and Environmental Management* 8.

<sup>125</sup> Edward Freeman, *Strategic Management: A Stakeholder Approach* (1988) in Belal, above n 1, 19.

<sup>126</sup> Berman et al., above n 122; Belal, above n 1, 19.

society.<sup>127</sup> The first approach, stakeholder power<sup>128</sup>; the second approach is the strategic posture (active vs. passive)<sup>129</sup> adopted by companies towards corporate social activities and the third approach is concerned with the economic performance of companies. Ullmann argues that the economic potency of companies affects corporate capacity to adopt CSR practices and disclosure, since economic strength affects the weight of social demands and the attention they receive from the top decision-makers in a company.<sup>130</sup> From this perspective, Deegan divides stakeholder approaches to corporate regulation into two groups: ethical and managerial.<sup>131</sup> The ethical approach emphasises the ongoing responsibility of companies to society and denotes directions in terms of how to deal with stakeholders, irrespective of their status. The managerial approach highlights managerial strategies to respond to stakeholder issues and denotes the details of the most appropriate strategies to deal with different types of stakeholders. In this approach, corporate responses to their stakeholders are determined by the extent to which the corporate managers consider the stakeholders as furthering the goals of the company.<sup>132</sup>

The power of stakeholder approaches and the strategic posture of companies are interrelated, depending on the economic impact of such a relationship.<sup>133</sup> The dimensions of the stakeholder approach described by Ullmann show that economically stronger companies are in a better position to maintain a higher level of CSR practices. Therefore, certain relative shortcomings in CSR practices may exist while they are being regulated at the corporate level. What is more interesting is that companies may have internal difficulties in regulating their CSR practices. However, these difficulties, as significant as they may be, do not render CSR practices unnecessary, since these practices are particularly implicated in the issues of labour accumulation and profit distribution. Robin Roberts argues that the unique features of the stakeholder approach highlight the possibility for companies to incorporate their stakeholders' strengths and therefore allow them to contribute within their context.<sup>134</sup> Companies could strengthen CSR practices if these

---

<sup>127</sup> Arie A Ullmann, 'Data in Search of A Theory: A Critical Examination of the Relationships among Social Performance, Social Disclosure, and Economic Performance of US Firms' (1985) *Academy of Management Review* 540; Belal, above n 1, 19.

<sup>128</sup> Belal, above n 1, 19; D. Neu, H. Warsame and K. Pedwell, 'Managing Public Impressions: Environmental Disclosures in Annual Reports' (1998) 23(3) *Accounting, Organizations and Society* 265, 278–279.

<sup>129</sup> Belal, above n 1, 19.

<sup>130</sup> Ullman, above n 131,553; MD López-Gamero, E Claver-Cortés and JF Molina-Azorín, 'Complementary Resources and Capabilities for an Ethical and Environmental Management: A Qual/Quan Study' (2008) 82(3) *Journal of Business Ethics* 701, 708.

<sup>131</sup> Deegan, above n 57, 294.

<sup>132</sup> Gray, above n 7, 46.

<sup>133</sup> Craig Deegan and Jeffrey Unerman, *Financial Accounting Theory* (2006) 272.

<sup>134</sup> Robin Robert, 'Determinants of Corporate Social Responsibility Disclosure: An Application of Stakeholder Theory' (1992). 17(6) *Accounting, Organization and Society*; for details, see Belal, above n 1, 19.



practices were gradually embedded into their day-to-day practice and included their surroundings.

To summarise, though it cannot be argued that the traditional framework of CG has totally failed in both legal and managerial terms, it can safely be stated that the conventional approach of corporate self-serving behaviour has been challenged by stakeholder theory.<sup>135</sup> The core themes and approaches of this theory entail comprehensive restrictions on such behaviour; its arguments prohibit any specific attention to the interests of a single constituent of any company. The arguments based on this theory attach a new meaning to CSR and corporate strategies.<sup>136</sup>

The aim of stakeholder theory is to redefine the purpose of business and its mode of response to its non-economic factors. It has challenged the traditional view that corporate activities should only be reflected by the signals from markets and the economic system. While CG is restricted to its shareowners and meant for profit maximisation, this theory ‘offers an alternative to both business and government institutions as to what is the very purpose of a business.’<sup>137</sup> Its precepts denote that companies are also responsible to ‘serve as a vehicle for coordinating stakeholder interests and to meet the claims of each of the group of stakeholders, who are affected by companies’ actions.’<sup>138</sup>

### 3.4 CSR Through Legal Regulation: ‘New Governance’ Argument

The authoritative role of one sole actor or a group of actors no longer dominates the scholarship and practice of governance. For instance, over the last two decades, the authoritative mode of regulation has been under considerable scrutiny. Argument rages between scholars and practitioners as to what the best rules will be in business practice, as authoritative regulation and state agencies are incapable of predicting the trend. In addition, the mechanisms for monitoring and adjusting these rules in the light of experience are severely lacking, especially in today’s uncertain world.<sup>139</sup> Michael Dorf puts it in this way: ‘[I]n the conditions of modern life, people increasingly find that their problem is not so much an inability to persuade those with different interests or viewpoints of what to do; their problem is that no

---

<sup>135</sup> Richard Warren, ‘The Evolution of Business Legitimacy’ (2003) 15(3) *European Business Review* 153, 154, 156. For details, see Deegan, above n 57, 292–293.

<sup>136</sup> The theory also explores the criteria on evaluating the legitimacy of CSR.

<sup>137</sup> Michael Hoffman and J.M. Moore, *Business Ethics: Readings and Cases in Corporate Morality* (1990) in Bichta, above n 37, 20.

<sup>138</sup> *Ibid.*

<sup>139</sup> Michael Dorf and Charles F Sabel, ‘A Constitution of Democratic Experimentalism’ (1998) 98 (2) *Columbia Law Review* 267, 278–279.

one has a complete solution to what collectively ails them'.<sup>140</sup> Two other vital reasons for this devolution in governance are that it becomes difficult for private actors alone to raise the compliance level<sup>141</sup> and that the state alone does not possess adequate resources to sufficiently help private actors to comply, to enforce the law, or to monitor and update rules in light of experience.<sup>142</sup>

Against this background, the arrival of NG can be deemed a new form of governance that assists the change in CG. The basic concept of NG is that it proposes many types of stakeholders and strategies to reach an optimal welfare level from any given perspective. In other words, this concept argues for 'collaborative governance' in which agencies and industry representatives work together to define and revise standards.<sup>143</sup> It is a rapidly growing concept.<sup>144</sup> The kinds of regulations included in NG tend to be less prescriptive, less top-down, and more focused on learning through monitoring than compliance with fixed rules. NG also provides scope for using a provisional and quasi-legislative framework that helps to 'set the terms of diffuse groups of stakeholders to elaborate in particular applications, which will then be reviewed at the centre with an eye toward revision of the frameworks.'<sup>145</sup>

The NG approach has contributed to changes in CG frameworks. Accordingly, the meaning of CG is changing; in the public marketplace of ideas, the term 'corporate governance' is also described as 'the set of processes, customs, policies, laws and institutions affecting the way in which a company is directed, administered or controlled.'<sup>146</sup> From the perspective of NG, the main feature of this devolution is that along with a functional economic focus, a public policy approach that seeks to protect investors as well as non-shareholder stakeholders is also important in CG. This devolution has also contributed to changes in the socio-legal view of corporate regulation.<sup>147</sup> In this form of governance, the role of law is

<sup>140</sup> Micheal Dorf, 'After Bureaucracy' (2004) *University of Chicago Law Review* 1245, 1269.

<sup>141</sup> Jody Freeman, 'Collaborative Governance in the Administrative State' (1997) 45 *UCLA L. Rev.* 1, 3.

<sup>142</sup> Jason M Solomon, 'Law and Governance in the 21st Century Regulatory State' (2007) 86 *Texas Law Review* 819, 822.

<sup>143</sup> Adam Winkler, 'Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History' (2004) 67(4) *Law and Contemporary Problems* 109; Michael Bradley et al., 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at A Crossroads' (1999) 62 *Law and Contemporary Problems* 9.

<sup>144</sup> For details on this concept, see Charles F. Sabel and William H. Simon, *Epilogue: Accountability Without Sovereignty*, Law and New Governance in the EU and the US (2006) 395; David M Trubek and Louise Trubek, 'New Governance and Legal Regulation: Complementarity, Rivalry and Transformation' (2007) 13 *Columbia Journal of European Law* 639; Neil Walker and Grainne De Burca, 'Reconceiving Law and New Governance' (2006) 13 *Columbia Journal of European Law* 519.

<sup>145</sup> Sabel and Simon, above n 150, 399.

<sup>146</sup> Corporate Governance [http://en.wikipedia.org/wiki/corporate\\_governance](http://en.wikipedia.org/wiki/corporate_governance) at 6 June 2011.

<sup>147</sup> Recent major corporate scandals have contributed to cg gaining attention as a public policy topic. These incidents have prompted legislators and businesses to allow greater scrutiny over

to catalyse a process of deliberation that ensures that different actors contribute to governance and learn from the results of one another's contributions, and that the regulator itself can learn from others.<sup>148</sup>

This section elaborates the intricacies of NG approaches to devolution into CG. Firstly, it discusses NG, CG and the nexus between them. Secondly, it discusses the impact of this nexus on the traditional pattern of CG and highlights the devolution into the dominant frameworks of CG and their shift towards the notions of NG. Finally, it concludes that NG has contributed to these shifts in the traditional format of CG.

### 3.4.1 *New Governance to Corporate Governance*

#### **New Governance**

NG comes from a conceptual background explaining how hardcore corporate decision-making and people-friendly business strategies have begun to converge, relying on executive fiduciary duty, stakeholder engagement, and economic analysis of management incentives.<sup>149</sup> It also addresses how companies incorporate

---

accounting manoeuvres and more transparency in order to prevent managers from engaging in fraud. After the enron crisis, the US President announced his 'ten point plan to improve corporate responsibility and protect America's shareholders' focusing on cg reform in the USA. Subsequently, the sarbanes-oxley act was passed. This Act, which introduced comprehensive accounting reforms for public companies and severe penalties for failure to comply, divided pro-business and pro-regulation advocates over the value of these reformative approaches and their political effects. For details see the President's leadership in combating corporate fraud at <http://georgewbush-whitehouse.archives.gov/infocus/corporateresponsibility/> at 6 June 2011; *Public Company Accounting Reform and investor Protection Act 2002* (USA) at [http://www.j-bradford-delong.net/movable\\_type/refs/2002-07-25-sarbanes.html](http://www.j-bradford-delong.net/movable_type/refs/2002-07-25-sarbanes.html) at 6 June 2011; Scott Harshbarger and Goutam Jois, 'Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance' (2007) 40(1) *Akron Law Review* 1.

<sup>148</sup> Michael Dorf and Charles Sabel's concept of 'democratic experimentalism' and 'directly deliberative polyarchy' are consistent of this view of law. For details, see Sabel and Simon, above n 150,284. For an example of how these approaches could be used in corporate regulation, see Archon Fung, Dara Rourke and Charles Sabel, 'Realising Labour Standards. Boston Review' (2007) 26 *Boston Review*, available at <http://bostonreview.net/br26.1/fung.html> 24 July 2011.

<sup>149</sup> Amir Gill, 'Corporate Governance as Social Responsibility: A Research Agenda' (2008) 26 *Berkeley Journal of International Law* 452, 463; regarding fiduciary duty aspect in NG, see Lyman Johnson and David Millon, 'Recalling Why Corporate officers are Fiduciaries' (2004) 46 *William and Mary Law Review* 1597; Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85(2) *Virginia Law Review* 247. For stakeholder aspect see, Mitchell, below n 168. For economic analysis, see Craig Mackenzie, 'Boards, Incentives and Corporate Social Responsibility: The Case for a Change of Emphasis' (2007) 15(5) *Corporate Governance: An International Review* 935; Jayson Scott Johnston, 'Signaling Social Responsibility: On the Law and Economics of Market incentives for Corporate Environmental Performance' (University of Pennsylvania, Institute for Law and Economic Research, 2005).

stakeholder-friendly business strategies,<sup>150</sup> examines the role of shareholder and board activism in pushing for social responsibility,<sup>151</sup> and provides quantitative assessments of reporting practices, indices and ratings that link governance with responsibility.<sup>152</sup> Finally, it suggests models for pursuing this emerging frontier through greater involvement on behalf of the board of directors and utilises a comparative approach to cross the border between CG and accountability.<sup>153</sup>

A visible change is marked in that the public policies that were traditionally imposed by formal regulatory bodies (e.g., workplace anti-discrimination and environmental-protection boards) are now being collaboratively addressed through participation, negotiation, and dialogue between the public and private sectors.<sup>154</sup> Accordingly, the regulatory tools themselves are shifting; they no longer consist exclusively of legislative or administrative acts but also contain market-oriented institutions that enforce business transparency, disclosure, reporting and monitoring practices as well as internal sanctions to tackle individual misconduct. The primary challenge for NG arrangements is how to create a suitable atmosphere and the appropriate conditions for these tools to work as effectively as possible.<sup>155</sup>

To function as a tool for regulation, NG highlights the need for public scrutiny and enforcement. It promotes new regulatory structures that require companies to track the growing public expectations for accountability. In fact, studies show that internal governance policies that emphasise social responsibility through transparency and coordination are more successful in bringing about ethical corporate conduct than traditional proscriptive regulation.<sup>156</sup> Moreover, contrary to the more traditional forms of regulation, proponents of NG believe that these structures

---

<sup>150</sup> Winkler, above n 145; Michael Bradley et al., 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads' (1999) 62 *Law and Contemporary Problems* 9.

<sup>151</sup> Adam Sulkowski and Kent Greenfield, 'A Bridle, A Prod, and A Big Stick: An Evaluation of Class Actions, Shareholder Proposals, and the Ultra Vires Doctrine as Methods for Controlling Corporate Behaviour' (2005) 79. *John Marshall Law Review* 929; Tomas W Joo, 'A Trip Through the Maze of Corporate Democracy: Shareholder Voice and Management Composition' (2003) 77. *John Marshall Law Review* 735.

<sup>152</sup> Ans Kolk, 'Sustainability, Accountability and Corporate Governance: Exploring Multinationals' Reporting Practices' (2008) 17(1) *Business Strategy and the Environment* 1; Meir Statman, 'Socially Responsible Indexes: Composition and Performance' (Leavey School of Business, Santa Clara University, 2005); Deegan, above n 57.

<sup>153</sup> See Generally Yadong Luo, *Global Dimensions of Corporate Governance* (2007); Arthur R. Pinto, 'Globalisation and the Study of Comparative Corporate Governance' (2005) 23 *Wisconsin International Law Journal* 477.

<sup>154</sup> David Hess, 'Social Reporting and New Governance Regulation: The Prospects of Achieving Corporate Accountability Through Transparency' (2007) 17 *Business Ethics Quarterly* 455; see also Orly Lobel, 'The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought' (2004) 89 *Minnesota Law Review* 342.

<sup>155</sup> John M. Conley and Cynthia A. Williams, 'Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement' (2005) 31 *Journal of Corporation Law* 1.

<sup>156</sup> Philip Selznick, *The Communitarian Persuasion* (2002) 101; see generally, John Braithwaite, *Crime, Shame, and Reintegration* (1999).

can and should be designed to rely less on state-dictated preferences and more on public–private collaboration, flexibility, and pragmatism.<sup>157</sup> Empirical evidence suggests that companies are more willing to consider effective ways of enforcing compliance standards and processes, as well as share more information, when they operate in a collaborative climate that allows them to perform their own monitoring.<sup>158</sup> Studies have shown that enforcing environmental protection through non-conventional regulatory tactics may also enhance corporate compliance with financial and workplace protection.<sup>159</sup>

The intricate combination of governance and responsibility characterising the post-Enron corporate transformation illustrates this decentralisation of regulatory power and the development of public–private monitoring agencies. The number of codes of conduct, best practices, and guidelines initiated by businesses, regulators, and administrative agencies serving as a primary source of business regulation is on the rise. NG finds its strongest expression in corporate conduct on this occasion. NG precepts have stimulated the development of new approaches, a ‘new learning’ about regulation. The theoretical approaches to regulation have evolved from interest-based to process-based approaches. In regulatory practices, disillusionment with the burden and inefficiencies of substantive regulation has further shifted the devolution from process-based regulation to system-based regulation. A systems approach to regulation has created scope for incorporating different modes in regulation; it denotes that regulation is a synbook of the principles of self-regulation, reflexivity, and responsiveness. Two important features of legal regulation within this synbooked mode of regulation are that legal regulation leads process where different actors can participate on a democratic basis, and that legal regulation aims to reach the full range of governance of a particular process.

### Corporate Governance

In the term CG, ‘governance’ comes from the Latin words *gubernare* and *gubernator*, which refer to steering a ship and the captain of a ship, respectively. This is the origin of the word governor. Another source of the word governance can be traced back to the old French word *gouvernance* meaning control and the state of being governed. Hence, the metaphoric meaning of this word is the idea of steering or captaining a ship, with the reference of control and good order.

---

<sup>157</sup> Bradley Karkkainen, ‘New Governance in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping’ (2004) 89 *Minnesota Law Review* 471.

<sup>158</sup> Cary Coglianese and David Lazer, ‘Management Based Regulation: Prescribing Private Management to Achieve Public Goals’ (2003) 37(4) *Law & Society Review* 691.

<sup>159</sup> Christine Parker and Vibeke Nielsen, ‘Do Corporate Compliance Programs influence Compliance?’ (University of Melbourne, 2006).

CG is an umbrella term.<sup>160</sup> In its narrow sense, it describes the formal system of accountability of corporate directors to the owners of companies. In its broad sense, the concept includes the entire network of formal and informal relationships involving the corporate sector and the consequences of these relationships to society in general.<sup>161</sup> These two senses are not contradictory; but rather, complementary. CG has been described as the ways in which suppliers of finance to companies assure themselves of getting a return on their investment.<sup>162</sup> However, it may also allude to ‘the whole set of legal, cultural, and institutional arrangements that determine what publicly traded companies can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.’<sup>163</sup> Taking both of these senses together, CG is no longer merely about maximising stock value.<sup>164</sup>

Within the CG framework in general, the roles, rights, and responsibilities of corporate directors are crucial.<sup>165</sup> In particular, the board of directors is the most appropriate body to design policies and allow corporate management to fulfil its responsibilities to society.<sup>166</sup> In most cases, this board is the sole body that communicates corporate performance to corporate owners. Moreover, with the beginning of the modern CSR era,<sup>167</sup> its role in CG has extended enormously; Eisenberg describes this as the ‘board as manager’.<sup>168</sup>

---

<sup>160</sup> For details of ‘Corporate Governance’ see Andre Shleifer and Robert Vishny, ‘A Survey of Corporate Governance’ (1997) 52(2) *Journal of Finance* 737; Shann Turnbull, ‘Corporate Governance: Its Scope, Concerns and Theories’ (1997) 5(4) *Corporate Governance* 180; Oliver Hart, ‘Corporate Governance: Some Theory and Implications’ (1995) 105(430) *The Economic Journal* 678; Marco Becht, Patrick Bolton and Alisa Röell, ‘Corporate Governance and Control’ (2003) 1 *Handbook of the Economics of Finance* 1; Catherine Daily, Dan Dalton and Albert Cannella Jr, ‘Corporate Governance: Decades of Dialogue and Data’ (2003) 28(3) *Academy of Management Review* 371; Lucian Bebchuk, Alma Cohen and Allen Ferrell, ‘What Matters in Corporate Governance?’ (2009) 22(2) *Review of Financial Studies* 783.

<sup>161</sup> K. Keasey, S. Thompson and M. Wright, *Corporate Governance: Economic and Financial Issues* (1997) 2.

<sup>162</sup> Shleifer and Vishny, above n 162.

<sup>163</sup> Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995) 3.

<sup>164</sup> Corporate Governance, [http://en.wikipedia.org/wiki/corporate\\_governance](http://en.wikipedia.org/wiki/corporate_governance) at 3 February 2011.

<sup>165</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (2008) 69–146.

<sup>166</sup> Lawrence E Mitchell, ‘The Board as A Path toward Corporate Social Responsibility’ in Doreen Mcbarnet, Aurora Voiculescu and Tom Campbell (Eds), *New Corporate Accountability* (2007) 280.

<sup>167</sup> For details of the corporate board of directors reform and the beginning of modern CSR, see Mitchell, above n 155, 284–288.

<sup>168</sup> Aron Eisenberg, ‘The Modernisation of Corporate Law: An Essay for Bill Cary’ (1982) 37 *University of Miami Law Review* 187, 209–210.

### 3.4.2 *The Nexus of New Governance and Corporate Governance*

The potential convergence of CG and CSR is frequently understood against the backdrop of the NG theory that identifies increased participation of the private sectors in shaping public policy and regulation.<sup>169</sup> According to scholars, global economic transformations can potentially decentralise state regulatory power.<sup>170</sup> Therefore, this convergence has been manifested by the replacement of the traditional hierarchical 'command-and-control' mode of regulation with a mixture of public and private, state and market, traditional and self-regulation institutions based on collaboration between states, companies, and NGOs.<sup>171</sup> This nexus urges that social actors other than the state and the company should actively participate in regulation, from the creation phase through to the monitoring phase. Social groups concerned include employee and consumer coalitions, public interest groups and international NGOs, and courts and legislators. It focuses on making self-regulation of corporate conduct more effective, rather than on replacing it with prescriptive legal regulation. Since enforceable legal frameworks are rare in the context of voluntary stakeholders of CG, it suggests an indirect strategy to oblige CG consider CSR as central to their internal business strategies. To this end, it creates environments to promote ground-level activism, advocacy, and media campaigns to influence CG acceptance of its social responsibilities.<sup>172</sup>

Scholars have devoted substantial attention to investigating the efforts undertaken by these civil actors (e.g., NGOs and non-profit companies) and companies to mandate this synbook by legal regulation.<sup>173</sup> To date, these efforts have concentrated on strategies such as working with companies to build their CSR tools through consulting, training, and publishing stock market indices and ratings that measure CSR performance.<sup>174</sup> Along with the development of the precepts of NG, multi-party involvement in regulation and monitoring is also developing as a vehicle through which CG and social responsibility converge. The changing nature

---

<sup>169</sup> Lester Salamon, 'The New Governance and the Tools of Public Action: An Introduction' (2000) 28 *Fordham Urban Law Journal* 1611.

<sup>170</sup> Orly Lobel and On Amir, 'Behavioural Versus Institutional Antecedents of Decentralised Enforcement in Organisations: An Experimental Approach' (2007) *Regulation*; see generally, Orly Lobel, 'Setting the Agenda for New Governance Research' (2004) 89 *Minnesota Law Review* 498.

<sup>171</sup> Orly Lobel, 'Interlocking Regulatory and Industrial Relations: The Governance of Workplace Safety' (2005) 57 *Administrative Law Review* 1071.

<sup>172</sup> Christine Parker, 'Meta-regulation: Legal Accountability for Corporate Social Responsibility?' in Doreen Mcbarnet, Aurora Voiculescu and Tom Campbell (Eds), *The New Corporate Accountability: Corporate Social Responsibility and The Law* (2007).

<sup>173</sup> Christine Parker, *The Open Corporation: Effective Self-Regulation and Democracy* (2002).

<sup>174</sup> Kees Bastmeijer and Jonathan M. Verschuuren, *NGO-Business Collaborations and the Law: Sustainability, Limitations of the Law, and the Changing Relationship between Companies and NGOs*, Corporate Social Responsibility, Accountability and Governance. Global Perspectives (2005).



of corporate monitoring, the identity of the social regulators participating in the process, and the substantive mechanisms unfolding to control corporate behaviour indicates the important role of this convergence. Laws, rules, or policies hold the key dimension of this convergence and drive the process underlying this convergence within companies with the aim of reaching a particular goal. This regulatory approach drives CG to think reflexively about regulation so that CG can insist that management initiate the strategies required to contribute to fulfilling public policy goals. Chapter 6 of this book describes the concept of meta-regulation, a form of legal regulation in which different stakeholders can contribute to reach a given goal and discusses the suitability of this form of regulation to assist in the incorporation of CSR principles in corporate self-regulation.

Read against the background of the NG literature, the shift of regulatory focus from the regulators' interest and projected outcomes to a systematic process captures a central element in the complexity of corporate regulation. These regulatory patterns accompany socio-legal changes in market economies, highlighted by the decline in state authority and private ordering.<sup>175</sup> They assist CG to acknowledge and pursue the synbook between old and new legal institutions, orthodox and novel social concepts, and conservative and liberal political conceptions.<sup>176</sup>

In NG, corporate morals and ethical behaviour find their expression in accountability mechanisms, transparency, and disclosure.<sup>177</sup> This has led to a semi-public legal debate in which corporate managers use governance as a synonym to describe their duties of care, fairness, and fiduciary responsibility simultaneously.<sup>178</sup> The agency focus in CG associated with the 'pro-business school' has gradually, yet overwhelmingly, cleared the way for a 'third way perspective' focus on ethics and accountability. CG is no longer merely about maximising stock value but rather about 'the relationships among the many players involved (the stakeholders) and the goals for which the company is governed.'<sup>179</sup>

Contemporary legal regulation scholarship's recognition of NG mechanisms that rely on co-enforcement also contributes to more effective CG strategies. This has led to the development of different regulatory strategies for CG to target their resources in a more sophisticated manner and direct corporate management to hold public policy goals as central in corporate self-regulation.<sup>180</sup> This development in CG has begun the process of convergence in the tensions between CG's engagement with shareholder and stakeholder interests. It has united the ethos of the CSR

---

<sup>175</sup> Orly Lobel, 'The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought' (2004) 89 *Minnesota Law Review* 1071; Parker, above n 175.

<sup>176</sup> Peer Zumbansen, 'The Parallel Worlds of Corporate Governance and Labour Law' (2006) 13 (1) *Indiana Journal of Global Legal Studies* 261, 299–305.

<sup>177</sup> Brian A. Warwick, 'Reinventing the Wheel: Firestone and the Role of Ethics in the Corporation' (2002) 54 *Alabama Law Review* 1455.

<sup>178</sup> Guhan Subramanian, 'Board Silly', *New York Times* 14 February 2007.

<sup>179</sup> Wikipedia, 'Corporate Governance' (2011).

<sup>180</sup> Lobel and Amir, above n 172.



movement that has helped the new notion of CG to reconcile this tension and render CG more attuned to constituency concerns. Business society has gradually accepted this development in the CG framework. When *The Economist* recently asked over 1,000 executives 'how [their] organisation[s] define corporate responsibility', 31.4 % of the respondents answered 'maximising profits and serving the interests of shareholders'.<sup>181</sup> This was the second most common answer after 'taking proper account of the broader interests of society when making business decisions', which was chosen by 38.4 % of respondents.<sup>182</sup> This development has methodological implications for the conceptual applications of CG and social responsibility. The study of CG is gradually beginning to incorporate concepts such as non-financial accountability, ethical codes and standards of conduct, socially driven investment and fiduciary duties, board diversity, stakeholder engagement, sustainability reporting, and socially responsible corporate strategies.<sup>183</sup> The discussion below highlights this issue.

### ***3.4.3 From the Nexus of New Governance and Corporate Governance to the Devolution into Corporate Governance Frameworks***

This section discusses how the nexus of NG and CG notions have impacted the devolution of the traditional CG framework into the dominant pattern of CG today. CG is instrumental in the attainment of fundamental social and economic goals. To reach these goals, numerous frameworks exist for CG, among which property justification for shareholder primacy is predominant, and challenges the inclusion of the core approach of NG in CG. The discussion below focuses on the devolution into this framework. To this end, first, it discusses shareholder primacy and the libertarian and economic justifications of shareholder primacy. Next, it presents the major arguments of team production and stakeholder pluralism, which maintain a NG approach and reject shareholder primacy in CG. Finally, it focuses on the development of enlightened shareholder primacy (ESP), which has acknowledged the NG approach in CG.

---

<sup>181</sup> Economist Intelligence Unit, *Global Business Barometer January 2008* (January 2008) The Economist <http://www.economist.com/media/pdf/barometer2.pdf> 13 June 2011.

<sup>182</sup> Ibid.

<sup>183</sup> Sandra Dawson, 'Balancing Self Interest and Altruism: Corporate Governance Alone is Not Enough' (2004) 12(2) *Corporate Governance: An International Review* 130.

## Shareholder Primacy

Shareholder primacy assumes that a corporate company should be run in such a way as to maximise the interests of the shareholders ahead of any other interested parties who might have claims against the company.<sup>184</sup> The principle of this concept is also known as ‘shareholder value’ or the ‘shareholder wealth maximisation norm’.<sup>185</sup> Under this principle, the objective of a company is to maximise the market value of the company ‘through allocative, productive, and dynamic efficiency.’<sup>186</sup> This concept argues that this corporate approach is the best way to secure overall prosperity and welfare in society.<sup>187</sup> Shareholder primacy is widely used in Anglo-Saxon jurisdictions such as the UK, Australia, Canada, and, most notably, the USA.

The basis of the concept of shareholder primacy is its argument that shareholders are the sole residual claimants of corporate property in the sense that they are entitled to whatever corporate assets are left once fixed claims have been met. According to traditional property justification, as shareholders own the property rights in a company, the company must be managed in their interest. This justification for property rights in companies affects the most of other provisions in CG. Based on this justification, this concept rests on the proposition that ‘the more amorphous the managers’ mandate is, the more difficult it is to determine whether the managers are faithfully and diligently accomplishing their mandate.’<sup>188</sup> The classic judicial affirmation of this is contained in the decision of *Dodge v. Ford Motor Co.*<sup>189</sup> in which the Michigan Supreme Court stated:

A business company is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not intend to a change in the

---

<sup>184</sup> See generally Stephen M Bainbridge, ‘Director Primacy: The Means and Ends of Corporate Governance’ (2002) 97 *Northwestern University Law Review* 547, 549, 552, 563; Stephen M Bainbridge, ‘In Defense of the Shareholder Wealth Maximisation Norm: A Reply to Professor Green’ (1993) 50 *Washington and Lee Law Review* 1423; Mark Roe, ‘The Shareholder Wealth Maximisation Norm and Industrial Organisation’ (2000) 149 *University of Pennsylvania Law Review* 2063.

<sup>185</sup> Andrew Keay, ‘Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom’s Enlightened Shareholder Value Approach’ (2007) 29 *Sydney Law Review* 577.

<sup>186</sup> Colin Mayer, ‘Corporate Governance, Competition, and Performance’ (1997) 24(1) *Journal of Law and Society* 152, 155.

<sup>187</sup> Keay, above n 191, 578.

<sup>188</sup> Ian B. Lee, ‘Efficiency and Ethics in the Debate about Shareholder Primacy’ (2006) 31 *Delaware Journal of Corporation Law* 533, 537.

<sup>189</sup> 170 N.W. 668, 684 (Mich. 1919); the core finding of the court is: ‘a business company is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the non-distribution of profits among stockholders in order to devote them to other purposes.’

end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.

This view is considered somewhat antiquated, as it assumes rather than justifies shareholder primacy.<sup>190</sup> It is not reflected in the state of the law, as shareholders do not have property rights in the company. The property rights held by shareholders are in its shares.<sup>191</sup> As it is a distinct legal entity, shareholders have no direct access to company assets. In this framework, other than the shareholders, several different parties have rights and claims in respect to the company, and there is no inherent reason to attribute priority to one type of claim.<sup>192</sup> (This point is elaborated upon in the discussion on the stakeholder pluralism critiques of shareholder primacy.)

Other arguments propound this concept. First, shareholders are in the best position to guide and discipline corporate directors, as corporate directors are the agents of the shareholders, according to agency theory.<sup>193</sup> It is argued that without this guidance, corporate directors would engage in opportunistic behaviour (known as 'shirking'). This behaviour would incur cost (commonly known as 'agency cost') on the company. Therefore, to reduce the incidents of shirking and to reduce agency costs, it is argued that shareholder value should be predominant in CG.

Second, shareholders have incentives to maximise profits, and therefore, they are more focused on economic efficiency than other parties in CG. Accordingly, shareholder primacy argues that CG should be solely focused to maximise shareholders' wealth, because 'the least cost is expended in having this as the object rather than something else'.<sup>194</sup> Parallel to this argument, this concept holds that corporate directors can work more efficiently if they are only focused on one objective.<sup>195</sup>

---

<sup>190</sup> Ewald Engelen, 'Corporate Governance, Property and Democracy: A Conceptual Critique of Shareholder Ideology' (2001) 31(3) *Economy and Society* 391; T. Clarke, *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (2004) 309.

<sup>191</sup> Bryan Horrigan, *Comparative Corporate Governance Developments and Key Ongoing Challenges From Anglo-American Perspectives*, Research Handbook on Corporate Legal Responsibility (2005) 39.

<sup>192</sup> Margaret Blair and Lynn Stout, 'Directors Accountability and the Mediating Role of the Corporate Board' (2001) 403(79) *Washington University Law Quarterly* 411–414.

<sup>193</sup> This is based on a large number of work, amongst those the most influential are: Michael C Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305; Eugene Fama, 'Agency Problems and the theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288; Eugene Fama and Michael Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301; Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1996).

<sup>194</sup> Mark E Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 56–57.

<sup>195</sup> Keay, above n 191, 584.

Third, corporate directors should not be engaged in a range of duties, as it would be impossible for them to balance all of their divergent interests, and therefore, it might interfere in their decision-making for the company.<sup>196</sup>

Fourth, shareholders are not able to protect themselves as other constituents are, since their liabilities in companies are not protected by any terms of contract. Shareholders find themselves in a vulnerable position, as unlike creditors, they do not have scope to negotiate special terms by way of contract and hence rely on the performance of the directors.<sup>197</sup> If shareholders do not have control over the work of corporate directors, as this concept argues, they may not be able to overcome the vulnerable situation in which they find themselves.<sup>198</sup>

Finally, shareholders cannot exit a company without considerable sacrifice, as 'while they can sell their share to another, the price obtained will take into account any shareholder exploitation'.<sup>199</sup> Jill Fisch's observation is noteworthy in this regard; she states: '[The shareholders] will bear the costs of misdeeds or self-dealing by other stakeholders even if they exit.'<sup>200</sup>

In their paper 'The End of History for Corporate Law', Henry Hansmann and Reiner Kraakman contend that the dominance of shareholder primacy has increasingly led to a convergence that leaves 'no serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.'<sup>201</sup> They describe the elements of the shareholder primacy 'consensus' as follows:

1. Control over the company should be in the hands of the shareholders.
2. Managers must manage the company in the interests of the shareholders.
3. Other corporate constituencies have their interests protected by contractual and regulatory means.
4. Non-controlling shareholders receive strong protection from exploitation.
5. The principal measure of the publicly traded company's shareholders is the market value of their share in the firm.

This unanimity is represented through a 'widespread normative consensus that directors should act exclusively in the economic interest of shareholders, including non-controlling shareholders.'<sup>202</sup> This convergence has occurred owing to the success of companies in jurisdictions where shareholder primacy predominates,

<sup>196</sup> The Committee on Corporate Law, 'Other Constituencies Statutes: Potential for Confusion' (1990) 45 *Business Lawyer* 2253, 2269.

<sup>197</sup> Luigi Zingales, in *The New Palgrave Dictionary of Economics and the Law* (1998) 501.

<sup>198</sup> Jill Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2005) 31 *Journal of Corporate Law* 637.

<sup>199</sup> Keay, above n 191, 584.

<sup>200</sup> Fisch, above n 204, 662.

<sup>201</sup> Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2000) 89 *Georgetown Law Journal* 439.

<sup>202</sup> *Ibid.*

the increasing influence of the academic disciplines of economics and finance, as well as the spread of share ownership and the advent of effective shareholder representative interest groups.<sup>203</sup>

### **Libertarian and Economic Justification for Shareholder Primacy**

The modern justification for shareholder primacy derives from both libertarian and economic considerations. As noted by Milton Friedman, there is tension between the need to organise production and distribution in modern society and the fundamental liberal concern of concentration of power.<sup>204</sup> This stand goes against the stakeholder pluralism model and places less emphasis on the arguments of team production theory; it broadens managerial discretion and ultimately undermines the strict accountability of directors to shareholders.

From a regulatory perspective, the implication of shareholder primacy is that corporate regulation should be essentially facilitative, and that regulatory intervention should be limited to encouraging competitive and informed markets. Within this framework, corporate directors are to maximise the future value of expected profits per share while complying with relevant public law requirements.<sup>205</sup> According to this concept, it is for the government and the courts to protect the interests of 'other corporate constituencies' by way of contract and regulation. This can be distilled even further by the argument raised by Butler. He proposes that 'companies should be as profitable as possible over the long term in the interests of their shareholders.'<sup>206</sup> Directors are therefore employed to ensure the maximum return for the risk ventured by shareholders.

### **A Team Production Critique of Shareholder Primacy**

The team production concept owes much to Armen Alchian and Harold Demsetz's characterisation of activity within corporate firms. They define corporate activities as a type of production that requires investment of resources by several contributors in circumstances in which the value created by them as a whole is observable.<sup>207</sup>

---

<sup>203</sup> Ibid 4; see generally D. Gordon Smith, 'The Shareholder Primacy Norm' (1997) 23 *Journal of Corporation Law* 277.

<sup>204</sup> Milton Friedman, *Capitalism and Freedom* (1982) 39.

<sup>205</sup> Steven Wallman, 'Understanding the Purpose of A Corporation: An introduction' (1998) 24 *Journal of Corporation Law* 807; Michael C Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

<sup>206</sup> See generally, Henry Butler, 'The Contractual Theory of the Corporation' (1988) 11 *George Mason University Law Review* 99.

<sup>207</sup> Armen A Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organisation' (1972) 62(5) *American Economic Review* 777, 779.

Margaret Blair and Lynn Stout extended this concept and argued that CG should consider that the corporate directors are not simply the agents of the shareholders charged with the maximisation of profits. Rather, as they argue, corporate directors should act as a 'mediating hierarch' and should be responsible for allocating the surplus produced by the company to the various team members such as investors, managers, employees.<sup>208</sup> These proponents have further extended the source of managerial discretion to 'sacrifice profits in the public interest.'<sup>209</sup>

Team production theorists challenge the justification for the rights of shareholders on corporate properties as the sole 'residual claimants'. They contend that there is nothing unique about shareholders' equity investment. On the contrary, a variety of parties, such as creditors, employees, managers, and even governments, often make significant firm-specific investments.<sup>210</sup> Employees may develop company-specific skills, and governments may invest in infrastructure to support a major company. These theorists maintain that these investments are not compensated by 'complete' contracts. This is a result of the difficulty of drafting contracts that deal with every eventuality and the fact that many parties rely on expectations not subject to complete agreements.<sup>211</sup> These expectations are often long running in nature and subject to the vagaries of market fluctuation and other external factors. Stakeholders engaging in a contractual relationship often surrender a significant amount of mobility in their reliance on these expectations, and their risk is therefore heavily tied to the fortunes of the contracting company. This means that other stakeholders also share the residual risk of corporate failure with the shareholders. Indeed, shareholders are often in a better position to manage their risk, as they are able to diversify their investment portfolio, and their shares offer greater liquidity than other types of investments.

These arguments illustrate the dilemma for the shareholder primacy model, as they show that situations may arise in which directors may make shareholders better off by simply appropriating value from other stakeholders. This is done despite having a negative impact on the total value of firm-specific investments and by becoming sub-optimal from a broader efficiency perspective.<sup>212</sup> Hence, team production theorists argue that directors should not be focused only on maximising

---

<sup>208</sup> Margaret Blair and Lynn Stout, 'Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 *Washington University Law Quarterly* 403, 404–405; Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85(2) *Vandebuilt Law Review* 247, 250–251.

<sup>209</sup> Einer Elhauge, 'Sacrificing Corporate Profits in the Public Interest' (2005) 80 *New York University Law Review* 733, 739. Some other noteworthy contribution in developing this concept are Lawrence E Mitchell, *Corporate Irresponsibility: America's Newest Export* (2001); Ian B. Lee, 'Corporate Law, Profit Maximisation and the "Responsible Shareholder"' (2005) 10 (31) *Stanford Journal of Law, Business and Finance* 442.

<sup>210</sup> Blair and Stout, above n 210, 259.

<sup>211</sup> Lynn Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2001) 75 *California Law Review* 1189, 1196.

<sup>212</sup> *Ibid* 1997.

shareholder value but instead should try to 'maximise the sum of all the risk-adjusted returns enjoyed by all the groups that participate in firms.'<sup>213</sup>

CSR arguments parallel the arguments of these theorists. CSR offers theoretical insights as to why companies should not be treated solely as their shareholders' private property but rather as semi-public companies based on sophisticated transactions and relational contracts among investors, managers, and employees.<sup>214</sup> CSR scholars suggest that applying the contractarian approach to corporate law (which portrays the company as a voluntary 'nexus of contracts')<sup>215</sup> as well as the realistic approach (which paints the company as a separate legal personality akin to a human being)<sup>216</sup> should not result in giving superior property rights to shareholders over employees. Rather, they posit, workers who invest their labour as an input in the company should enjoy legal recognition of their residual interest in the company's assets.<sup>217</sup>

### A Stakeholder Pluralism Critique of Shareholder Primacy

In CG, stakeholder pluralism argues that the objective of the company is to benefit all those who have contributed to the development of business gains.<sup>218</sup> Corporate directors are responsible for managing the company not only to ensure profits for shareholders but also in the interests of a multitude of stakeholders who can affect or be affected by the actions of a company.<sup>219</sup> According to this concept, corporate directors are liable to balance the interests of various stakeholders, including shareholders, in deciding the appropriate course of action required for governing a company.<sup>220</sup> This approach is 'premised on the theory that groups in addition to shareholders have claims on a company's assets and earnings because those groups

---

<sup>213</sup> Ibid 1998.

<sup>214</sup> Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 (2) *Vanderbilt Law Review* 247.

<sup>215</sup> Michael Klausner, 'The Contractarian theory of Corporate Law: A Generation Later' (2005) 31 *Journal of Corporation Law* 779, 782–784; Melvin Eisenberg, 'The Conception that the Corporation is A Nexus of Contracts, and the Dual Nature of the Firm' (1998) 24 *Journal of Corporation Law* 819, 825–826.

<sup>216</sup> David S. Allen, 'The First Amendment and the Doctrine of Corporate Personhood' (2001) 2 (3) *Journalism* 255.

<sup>217</sup> Kent Greenfield, 'The Place of Workers in Corporate Law' (1997) 39 *Boston College Law Review* 283; William Allen, 'Our Schizophrenic Conception of the Business Corporation' (1992) 14 *Cardozo Law Review* 261.

<sup>218</sup> Keay, above n 191, 578.

<sup>219</sup> Freeman, above n 37 in Tom L Beauchamp, Norman E Bowie and D.G. Arnold, *Ethical Theory and Business* (2001) 69.

<sup>220</sup> Edward E Freeman, 'The Politics of Stakeholder theory: Some Future Directions' (1994) 4 (4) *Business Ethics Quarterly* 409.

contribute to a company's capital.'<sup>221</sup> This approach is used in many continental European jurisdictions' CG systems, most notably, in Germany.<sup>222</sup>

The source of these stakeholder pluralism arguments in the CG framework is the role of long-term thinking in investment policies and management decision-making. The core argument of this concept is that companies exist to serve a number of stakeholders rather than shareholders alone.<sup>223</sup> The notion that stakeholder pluralism critiques shareholder primacy was advanced in 1932 by Berle and Means, who documented the separation of ownership and control occurring in the majority of large public companies. They showed that due to the broad dispersal of share ownership, no individual could control or adequately monitor the company. They concluded that this justified a fundamental reconceptualisation of property, in which 'the passive property right of today must yield before the larger interest of society.'<sup>224</sup> In this system of CG, the role of the board would be to act as 'a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity.'<sup>225</sup>

Other critiques of shareholder primacy in CG also propound this concept. First, this concept critiques the arguments in favour of 'shareholder value'. This concept considers that this value produces a short-term process. This focus overshadows all else and fails to maximise social wealth.<sup>226</sup> In this regard, Larry Mitchell has noted that CG in the USA is deleterious for various groups of stakeholders, as it is overly focused on turning over short-term profits in order to benefit shareholders.<sup>227</sup>

Second, 'the emphasis on the shareholders being residual risk-bearers is misplaced vis-à-vis other stakeholders.'<sup>228</sup> Other than the shareholders, as this is

---

<sup>221</sup> Roberta S Karmel, 'Implications of the Stakeholder Model' (1992) 61 *George Washington Law Review* 1156, 1171.

<sup>222</sup> Keay, above n 191, 578.

<sup>223</sup> Damien Grace and Stephen Cohen, *Business Ethics: Australian Problems and Cases* (1998) Chap. 3; Thomas Clarke and Stewart Clegg, *Changing Paradigms: The Transformation of Management Knowledge for the twenty-first century* (1998) Chap. 6.

<sup>224</sup> Adolf Berle and Gardiner C Means, *The Modern Corporation and Private Property* (1991) 80.

<sup>225</sup> Ibid.

<sup>226</sup> Steven Wallman, 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties' (1991) 21 *Stetson Law Review* 163, 176–177; see also Martin Lipton and Steven Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) *University of Chicago Law Review* 187, 203, 205–215; Mark E Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 61.

<sup>227</sup> Larry Mitchell, *Corporate Irresponsibility: America's Newest Export* (2001); for a critic of the whole notion of shareholder maximisation in corporate law, see Lawrence Mitchell, 'Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes' (1991) 70 *Texas Law Review* 579.

<sup>228</sup> Keay, above n 191, 585.



argued, stakeholders are also put in a vulnerable position because of their firm-specific investment. For instance, employees who have invested their time and effort in acquiring a certain skill to meet a certain company requirement may have limited prospects in the job market, as they may be unable to move to a different employer and gain from the training undertaken. This situation could create scope for ransom from the perspective of a company. Rather, there are arguments that shareholders are in a more flexible position to diversify risk more easily than other stakeholders.<sup>229</sup>

Third, a vital drawback of the concept of shareholder primacy is that it has undermined the very idea that companies are separate and independent legal entities.<sup>230</sup> Shares are clearly shareholders' property, but the company is not. According to scholarship and practice related to the concept of 'company', shareholders do not have rights to point to any property held by the company and assert ownership rights over it. Hence, the control of the shareholders over the corporate boards does not match the concept of company.

Finally, companies should serve broader social purposes than simply generating profits for shareholders, since they are involved in, and dealing with, companies that include human beings. Hence, CG should not be depersonalised. Communitarian theorists identify social and political values in CG, since they argue that the assessment of whether the company is useful is measured by its performance in gaining a richer understanding of community and respect for human dignity and overall welfare.<sup>231</sup> They contend that people are part of a shared community who 'inherit the benefits, values and goals of the community; thus the cultural milieu in which people find themselves cannot be ignored.'<sup>232</sup> Hence, they regard the concept of company as 'a community of interdependence, mutual trust, and reciprocal benefits.'<sup>233</sup> Moreover, they consider that the effect of invoking the shareholder value approach in CG damages the chances of non-shareholder contribution to corporate development; this preference would subordinate the non-shareholder stakeholders' firm-specific investments at all times.<sup>234</sup> Lyman Johnson's commentary is prominent in this respect. He states that 'a radically pro-shareholder vision of corporate endeavour [is] substantially out of line with prevailing social norms',<sup>235</sup>

---

<sup>229</sup> Keay, above n 191, 586.

<sup>230</sup> Ibid 586.

<sup>231</sup> Daniel Sullivan and David Conlon, 'Crisis and Transition in Corporate Governance Paradigms: The Role of the Chancery Court of Delaware' (1997) 31(4) *Law & Society Review* 713 in Janet Dine, *Company Law* (2001) 27–30.

<sup>232</sup> David Millon, 'New Directions in Corporate Law: Communitarians, Contractarians and the Crisis in Corporate Law' (1993) 50 *Washington and Lee Law Review* 1373, 1382.

<sup>233</sup> David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *Progressive Corporate Law: New Perspectives on Law, Culture and Society* (1995) 10.

<sup>234</sup> Gavin Kelly and John Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach*, *The Political Economy of the Company* (1998) 131.

<sup>235</sup> Lyman Johnson, 'Delaware Judiciary and the Meaning of Corporate Life and Corporate Law' (1989) 68 *Texas Law Review* 865, 934.

and therefore, the meaning of corporate endeavour should embrace norms ‘wider than the thin thread of shareholder primacy.’<sup>236</sup>

Stakeholder pluralism in CG suggests that the role of company directors would be to mediate the competing interests of various stakeholders.<sup>237</sup> This includes both contractual stakeholders (e.g., shareholders, employees, customers, distributors, suppliers, and lenders) and community stakeholders (e.g., customers, regulators, governments, pressure groups, the media, and local communities).<sup>238</sup> Each of these parties has different expectations of the company, and the company is accountable to each in different ways. For instance, shareholders expect dividends and share price appreciation, and the company is accountable by means of its annual reports and continuous disclosure obligations, while the general public expects safe corporate operations and corporate accountability. The leading advocate of this approach, Edward Freeman, and his co-author express the rationale of this approach in this way:

Business is about putting together a deal so that suppliers, customers, employees, communities, managers and shareholders all win continuously over time. In short, at some level, stakeholder interests have to be joint—they must be travelling in the same direction—or else there will be exit, and a new collaboration formed.<sup>239</sup>

The stakeholder pluralism arguments in CG have shifted the rights of a person or a group from an acceptable proposition to the idea that this right is enforceable and CG is also subject to ideas on ethics, social justice, and moral sense.<sup>240</sup> Germany

---

<sup>236</sup> Ibid 934.

<sup>237</sup> There are some models that describe the strategies for incorporating stakeholders in corporate regulation. Amongst these models, Clarkson’s risk-based models, the normative stakeholder accountability model and the managerial stakeholder model are noteworthy. The underlying notion in Clarkson’s risk-based model is that ‘a stake represents some form of risk and that without risk there is no stake’ and hence the rights of stakeholders in any strategy should be based on the stakeholder’s liabilities. On the basis of this notion, this model divides stakeholders into two groups: voluntary stakeholders and involuntary stakeholders. For details see M.B.E. Clarkson, ‘A Risk Based Model of Stakeholder theory’ (1994) 1; Belal, above n 1, 21. The normative stakeholder accountability model argues that the corporate strategies related with stakeholders should not be based on the ability of the stakeholder; rather, it is the duty of the company to look after the interest of all stakeholders without dividing them according to their ability to further the economic objective of the company. For details, see Craig Deegan and Jeffrey Unerman, *Financial Accounting Theory* (2006); Belal, above n 1, 21. The managerial stakeholder model puts emphasis on the strategies to relate the voluntary stakeholders with corporate issues in accordance with their abilities to further corporate interests. For details, see generally Gray, above n 7.

<sup>238</sup> Ewald Engelen, *Corporate Governance, Property and Democracy: A Conceptual Critique of Shareholder Ideology*, *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (2004) 309.

<sup>239</sup> Edward Freeman, Andrew Wicks and Bidhan Parmar, ‘Stakeholder Theory and “the Corporate Objective Revisited”’ (2004) 15 *Organization Science* 364, 365; see also Sankaran Venkataraman, *Stakeholder Value Equilibration and the Entrepreneurial Process*, *Ethics and Entrepreneurship* (2002) 45.

<sup>240</sup> John Plender, *A Stake in the Future: The Stakeholding Solution* (1997) in Janice Dean, *Directing Public Companies: Company Law and the Stakeholder Society* (2001) 117; see also Freeman, above n 227, 413.

and Japan are prominent for maintaining a scale of values based on different types of moral sense and ethics. In Germany, co-determination and worker representation on the supervisory boards of companies are common, while in the UK, CG allows corporate directors to consider employee issues that are beyond the contractual agreement. Recently, even a number of US states have created constituency statutes that allow consideration of a broad range of stakeholders.<sup>241</sup> This devolution in the scholarship of CG has paved the way for ESP, a considerably new concept in the CG framework.

### Enlightened Shareholder Primacy

The development of ESP dates back to the debate between Professor Adolf Berle and E Merrick Dodd concerning the objectives of a company. Berle argued that corporate directors should not, as managers of companies, have any responsibilities other than to shareholders and that their focus should be only upon making money.<sup>242</sup> On the other hand, Dodd argued that companies are economic institutions and that they should therefore have liabilities to contribute to social development along with the responsibility of generating profits for investments.<sup>243</sup> While the arguments of Berle have largely been adopted, especially in the USA, the arguments of Dodd have successfully paved the way for a college of scholarship on the societal approach in CG. This seminal debate, and the practices following the proponents of this debate, has gradually raised the argument for ESP that allows corporate directors to consider the interests of their constituencies, other than their shareholders, in the actions they take. This has also created the scope for directors to design their strategies for the long-term wellbeing of a company. In this regard, in many jurisdictions, courts have stated that CG can make commercial judgments based on the interest of non-shareholder interest in the management of the company.<sup>244</sup> Accordingly, this concept in shareholder primacy has moderated directors' obligations to manage the company to ensure only short-term benefits, such as maximising immediate profits.<sup>245</sup>

<sup>241</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (2008) 451.

<sup>242</sup> Adolf A Berle, 'Corporate Powers as Powers in Trust' (1930) 44 *Harvard Law Review* 1049. See also Adolf A Berle, 'For Whom Corporate Managers Are Trustees: A Note' (1931) 45 *Harvard Law Review* 1365; Adolf A Berle and Gardiner Means, *The Modern Corporation and Private Property* (1991).

<sup>243</sup> E Merrick Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45(7) *Harvard Law Review* 1145, 1148; see also E Merrick Dodd, 'Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?' (1935) *University of Chicago Law Review* 194.

<sup>244</sup> For some instances of court decisions, see *Provident International Company V International Leasing Corp Ltd* [1969] 1 NSW 424, 440; *Paramount Communications Inc V Time Inc* 571 A. 2d 1140 (Del, 1989).

<sup>245</sup> Corporations and Market Advisory Committee, 'Social Responsibility of Corporations' (CMAC, 2006) 84–89. Available at [http://www.camac.gov.au/camac/camac.nsf/byheadline/pdf/final-reports+2006/\\$file/csr\\_report.pdf](http://www.camac.gov.au/camac/camac.nsf/byheadline/pdf/final-reports+2006/$file/csr_report.pdf) at 8 June 2011.

The narrow approach of shareholder primacy in CG, a contemporary variation of shareholder primacy theory, is the main source of the development of ESP. Recent literature has utilised the term ‘enlightened shareholder value’ or ‘enlightened self-interest’ to indicate that although shareholder value is paramount, careful consideration of stakeholder interests is usually in the interest of the company.<sup>246</sup> This development in shareholder primacy accepts that good management should involve assessing the impact of a particular decision considering the likely consequences for corporate reputation. It has paved the way for corporate management to attract and retain employees and minimise transaction costs and risk by incorporating social policy goals at the centre of their strategies.<sup>247</sup>

ESP suggests that corporate directors ought to be empowered to consider the interests of stakeholders while maintaining shareholder primacy. This has given new insights into how companies are run and operated on a daily basis within the precepts of CG. It relates to the social welfare-driven approaches to CG and policy, and proposes that business efficiency should not only aim at higher stock prices but also at internalising environmental and social externalities and acknowledging the often unequal distributive consequences of creating corporate surpluses.<sup>248</sup> However, this concept does not undermine the interests of shareholders. Rather, it adds stakeholders’ interests to the CG framework along with shareholders’ interests. To avoid ambiguity, consider the following instance: where there are two routes a company can take, X and Y, where both benefit the company equally but where X may benefit one or more constituency interests and Y may not, then according to this concept, X should be adopted. Corporate management should not take a course of action that clearly provides benefits to a number of constituencies but does not provide any benefits to shareholders. Thus, this concept emphasises moral arguments associated with justice, fairness, and communitarianism<sup>249</sup> and endorses doctrinal approaches that reject the exclusivity of cost-benefit analysis and the exclusion of distributive aspects from efficiency models focused on maximising each transaction’s dollar value.<sup>250</sup>

---

<sup>246</sup> Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value* (2006) 46; see also UK Steering Group, *Modern Company Law for A Competitive Environment: The Strategic Framework* (1999) 5, 41.

<sup>247</sup> UK Steering Group, *Modern Company Law for A Competitive Environment: The Strategic Framework* (1999) 3.16–3.61.

<sup>248</sup> Kent Greenfield, ‘New Principles for Corporate Law’ (2005) 1 *Hastings Business Law Journal* 87; Lawrence Mitchell, ‘Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes’ (1991) 70 *Texas Law Review* 579.

<sup>249</sup> Kent Greenfield, ‘Corporate Social Responsibility: There’s A Forest in Those Trees: Teaching About Corporate Social Responsibility’ (2000) 34 *Georgia Law Review*. 1011; Ronen Shamir, ‘The Age of Responsibilisation: On Market-Embedded Morality’ (2008) 37(1) *Economy and Society* 1.

<sup>250</sup> For a recent critique of the existing scholarship of corporate regulation thought, see generally Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* (2006).

There are other arguments in support of ESP. First, this approach legitimises the far-sighted strategies in CG; it supports corporate directors' and senior managers' initiatives by considering the interests of non-shareholder stakeholders as long as these initiatives foster corporate profits. In its report 'Corporate Responsibility: Managing Risk and Creating Value', the Australian Parliamentary Joint Committee on Companies and Financial Services observed that the rate of social responsibility in business decision-making has increased in recent times. This report mentions that many directors of Australian companies make decisions founded on social responsibility as well as the interests of shareholders. The Committee mentions that '[p]rogressive, innovative directors, in seeking to add value for their shareholders, will engage with and take account of the interests of stakeholders other than shareholders.'<sup>251</sup> Fiona Buffini reported a comment from Ms Meredith Hellicar, the Chairwoman of the substantive James Hardie Group, who mentioned that corporate directors are aware of the threat from the shareholders and the possibility of being the object of legal suits, even though they are engaging more in CSR plans in the belief that their shareholders are enlightened and that the majority of them agree with the nexus of CSR and long-term profit.<sup>252</sup>

Second, ESP permits corporate directors to focus on long-term interests. It is accepted that most shareholders prefer to earn a stable rate of profit over the long term; not all shareholders want directors to focus on short-term benefits.<sup>253</sup> The Australian Parliamentary Joint Committee on Companies and Financial Services is of the view that most shareholders prefer to support corporate responsibility, as they believe that this will lead to long-term gain for shareholders.<sup>254</sup> At this point, Hansmann and Kraakman mention that there is 'no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.'<sup>255</sup>

Finally, ESP allows corporate directors to decide corporate issues based on their own conscience and economic justification; it does not require directors to balance the interests of a wide range of constituents. According to this approach, 'directors merely have to state that what they did was a result of balancing interests, and no

---

<sup>251</sup> Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value* (2006) 59.

<sup>252</sup> Fiona Buffini, 'Calls to Protect Corporate Conscience', *Australian Financial Review* (Sydney) 2005, 4; see also L.E. Preston and H.J. Sapienza, 'Stakeholder Management and Corporate Performance' (1990) 19(4) *Journal of Behavioral Economics* 361.

<sup>253</sup> International Accounting Standards Board, 'Discussion Paper on Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information' (2006) in Investment Management Association, 'IMA Response to Discussion Paper on An Improved Conceptual Framework for Financial Reporting' (2006) 4.

<sup>254</sup> Parliamentary Joint Committee on Corporations and Financial Services, above n 253, 50.

<sup>255</sup> Hansmann and Kraakman, above n 203; see also Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297.

one could challenge the conclusion at which they arrived.<sup>256</sup> The move towards this enlightened approach has contributed to the inclusion of NG notions in CG.<sup>257</sup> NG defines this transformation as a convergence of business self-interest and the interest of society to ensure that companies perform their social responsibilities.

To summarise, the dominant position of shareholder primacy has been minimised within the CG framework, where issues related to companies' public policy and social responsibility are now significant. Of late, ethical norms and the need for accountability have been two of the driving sources of CG, and with CSR being increasingly adopted in existing business practices, the potential convergence between CG and CSR comes to the foreground. Whereas previously there were two separate mechanisms of CG—one catering to 'hardcore' corporate decision-making and the other to 'soft' people-friendly business strategies—scholars are currently considering the more hybridised, synbooked body of laws and norms that regulate corporate practices. NG provides scope of such convergence in CG frameworks. The nexus between the NG and CG approaches in the face of regulatory, business, and social change has somewhat decreased the controversy over both the potential and the limitations of corporate accountability mechanisms. It enables scholars and practitioners in many fields to look beyond their traditional perspectives to explore ways in which synbooking governance and responsibility may change existing practices in business and social advocacy.

### 3.5 Conclusion

This discussion of legitimacy theory, stakeholder theory, and NG explains that the demand for incorporating CSR principles into corporate regulatory mechanisms is adequately supported by theory and is philosophically well grounded. These theories are based on moral arguments in favour of justice, fairness, and communitarianism. They are endorsed by doctrinal approaches that reject the exclusivity of cost-benefit analysis and include distributive aspects in efficiency models focused on maximising profits. From these theoretical bases, CSR is relevant to how

---

<sup>256</sup> Keay, above n 187, 602.

<sup>257</sup> Based on this approach, different economies are incorporating different strategies into their corporate regulation. For instance, the operational and financial review completed in the UK was built on the concept of 'enlightened shareholder value', that is, it was designed to provide shareholders with better information concerning company performance. The EU adopted this approach in its modernisation directive that requires a balanced review of a company's non-financial key performance indicators, including information relating to environmental and employee matters. The European Management Audit Scheme and the *Companies Act 2006* (UK) are other instances where considerable weight has been given to this approach. For details, see Filip Gregor, 'How Can Reporting Become A Relevant tool for Corporate Accountability at the European Level?' (2007) *Discussion Paper for European Coalition for Corporate Justice* [http://ec.europa.eu/company/policies/sustainable-business/corporate-social-responsibility/reporting-disclosure/swedish-presidency/files/position\\_papers/how\\_can\\_reporting\\_become\\_a\\_relevant\\_tool\\_en.pdf](http://ec.europa.eu/company/policies/sustainable-business/corporate-social-responsibility/reporting-disclosure/swedish-presidency/files/position_papers/how_can_reporting_become_a_relevant_tool_en.pdf) at 14 July 2011.

business considers the existing political and economic landscape and enables companies to adopt ethical guidelines, incorporate stakeholder concerns and to more efficiently internalise the costs previously externalised to the environment and society.<sup>258</sup> Shifts in the political economy are gradually promoting these fundamental changes in CG, largely by relying on the changing role of companies and their license to operate within society.

This has been reflected in studies of CG and CSR regulation in the strong economies. For instance, the OECD's recent publication of CG principles defines the basis of an effective CG framework: it 'should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.'<sup>259</sup> It considers that CG is instrumental in reaching fundamental social and economic goals, and emphasises that the CG framework should be developed with a view to its impact on overall economic performance, market integrity, and the incentives it creates for market participants and the promotion of transparent and efficient markets. Regarding the legal and regulatory requirements, as this organisation describes, CG should be 'consistent with the rule of law, transparent and enforceable.' It further mentions that the division of responsibilities in CG should be 'clearly articulated and ensure that the public interest is served.' However, such a framework is absent in the weak economies. The CG laws of these economies have not yet clearly taken CSR on board. The convergence of CG and CSR in the strong economies is of limited relevance to weak economies like that of Bangladesh.<sup>260</sup> At this juncture, the precepts of legitimacy theory, stakeholder theory and NG are becoming increasingly important for the regulation of CG and CSR in the weak economies; they have gradually reduced the profit-centric focus of their companies in general and made room for an alternative way of focusing on the pluralisation of actors, ethics, and accountability in corporate self-regulation.

---

<sup>258</sup> Gill, above n 151, 461; see generally, Doreen Mcbarnet, Aurora Voiculescu and Tom Campbell, *The New Corporate Accountability: Corporate Social Responsibility and the Law* (2007); David Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (2005).

<sup>259</sup> OECD, *OECD Principles of Corporate Governance* (2004) 17.

<sup>260</sup> The impact of such drawbacks in Bangladesh has been discussed in Chap. 6 of this book.