

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ





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NAE

Stock exchange

Stakeholders

Shareholders

Pakistani corporations

Dedicated to

My Magnificent *Father*

and

My Lovely *Mother*

Naima Iffat

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Approval Sheet

An examination of shareholder versus stakeholder theory in relation to corporate governance

By

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Accepted by the Faculty of Shariah and Law, International Islamic University Islamabad (IIUI) in partial fulfillment of the requirements for the award of the Degree of LLM (Corporate Law)

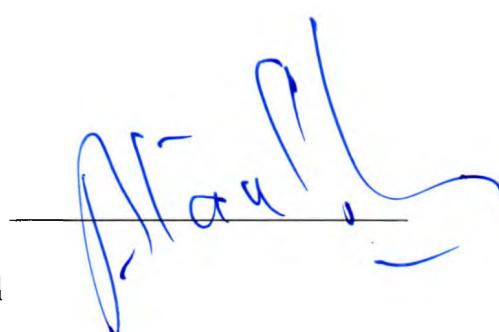
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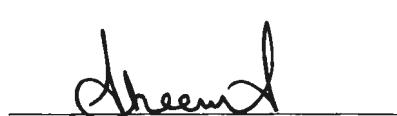
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Declaration

I, **Naima Iffat**, hereby declare that this dissertation is original and has never been presented in any other institution. I, moreover, declare that any secondary information used in this dissertation has been duly acknowledged.

Naima Iffat

Acknowledgment

Alhamdulillah and His eternal blessings be upon Muhammad, the last prophet (peace be on Him) for giving me the opportunity and courage to complete this humble work. Though interesting, the topic was challenging and complicated. Yet Alhamdulillah I was able to complete it with the help of few people to whom I owe my sincere gratitude.

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LIST OF ABBREVIATIONS

BOD	Board of Directors
CSR	Corporate Social Responsibility
CEO	Chief Executive Officer
FDI	Foreign Direct Investment
FSA	Financial Services Authority
IMF	International Monetary Funds
NASDAQ	National Association of Securities Dealers Automated Quotations
NYSE	New York Stock Exchange
OECD	Organization for Economic Cooperation and Development
PICG	Pakistan Institute of Corporate Governance
SBP	State Bank of Pakistan
SECP	Security Exchange Commission of Pakistan
SEBI	Securities and Exchange Board of India
WGI	Worldwide Governance Indicator

Abstract

The main purpose of this research is to suggest the best suited corporate governance model based on appropriate theory after analyzing the theoretical framework of both shareholder and stakeholder theory and two opposing model of corporate governance applicable all over the world. The corporate governance models based on diverse approaches like Anglo Saxon and European continental has been critically reviewed. Furthermore, the convergence of these two approaches and theories in scenario of current corporate world and trends and causes behind this convergence have also been addressed. The effects of this rapid convergence in form of hybrid model of governance and emergence of enlightened shareholder primacy theory has been considered with reference to the protection of stakeholders other than shareholders. In view of enlightened shareholder primacy theory it has also been evaluated that how shareholders and stakeholders both are crucial for long term profitability of corporation and sustainability of developing economies. Consequently, the legal reforms regarding implementation of appropriate corporate governance model based on appropriate theory has been suggested while taking into account the contemporary issues of corporate governance, current corporate culture and ownership structure of Pakistani corporations. It has been suggested that the representation on board should be given to the stakeholders and legislation should be made for the protection of stakeholders including shareholders as whole. Furthermore, the hybrid model of governance is more suitable to the ownership structure of Pakistani corporation.

Thesis Statement

Hybrid model of corporate governance based on two opposite shareholder and stakeholder theory could lead to increase financial performance of corporations as whole and its implementation in Pakistan would be suitable to the indigenous corporate culture and structure.

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CHAPTER 1:

1.1 INTRODUCTION

In the mid of nineteenth century, the milestone development was achieved by granting the status of legal persons and distinct liability to the corporations. Consequently, the existence of corporations was no more dependent on its partners or shareholders. Great depression caused the evolution of new corporate world and the partnerships were replaced by the companies with separate legal entity and limited liability. At the same time the capitalism based countries were converted to disperse ownership structure than family owned and concentrated ownership. The public offering of the shares of large corporations led to the dispersion of share-ownership in the hands of individuals and institutions. The corporate reality of dispersed ownership realized the separation of control from ownership.

The significant increase of corporate activities with the reality of dispersed share-ownership and separation between control and ownership raised the corporate governance issues. The evolution of large corporations having its shareholders in all over the world led to a problem of its control and governance. Subsequently, the separation of ownership and control become inevitable for governance and survival of the corporations. The crash of 1929 strengthened the view of corporate governance regarding separation of ownership and control in the corporation.¹ The scholars of that era were focusing on the proposal that the primary purpose of the corporations should be the protection of its shareholders or investors in any case and maximize the profit of its investors.

¹H. Kent Baker and Ronald Anderson, *Corporate Governance: A Synthesis of Theory, Research, and Practice* (New Jersey: John Wiley & Sons Inc., 2010) 176.

In present scenario of the business world which is changing rapidly, most of the researchers, corporate scholars have faith and perception that the only object of company is to protect and maximize the wealth of its owners. This assumption or statement is called shareholder capitalism which is based on classical economic and financial theory. On the other hand the stakeholder theory is referred as opponent to the shareholder capitalism and this theory is based on corporate social responsibility theory. Aforementioned two theories are opposing to each other regarding the purpose of Modern Corporation. The origin of shareholder theory relates to the economic perspective as it only concentrates on value maximization of its owners and it does not promote the interaction of corporation with its other constituencies and its role in society. Conversely, the stakeholder theory broadly recognizes the idea of value creation of stakeholders as whole and it also encourages the corporation's relationship with its other stakeholders and its impact on society at large.

We will discuss the foundations of these two theories with an overview of each theory and will conclude with some suggestions that how the shareholders and stakeholders both are crucial to achieve the objective of corporation.² The shareholder theory is prevailing all over the world and law is made on the basis of this theory particularly in common law systems or countries where capitalism is prevailing. Shareholder theory or capitalism has recently come under much criticism and the stakeholder view is often put forward as an alternative there is ongoing debate in Europe that shareholder theory has failed to stable the corporate market, economy and to maximize the profit of shareholders ultimately corporations are unable to achieve the main purpose or object of it. Moreover, in recent years the common law system including half of U.S. states enacted the legal reforms that require the directors to consider the interest of stakeholders

²Michael D. Pfarrer, "What is the Purpose of the Firm?: Shareholder and Stakeholder Theories" http://www.enterpriseethics.org/Portals/0/PDFs/good_business_chapter_07.pdf (accessed March 8, 2013).

while performing their duties.³ These two opposing theories having different notions define the duties of directors towards shareholders and stakeholders regarding protection of their interest. In this paper, after the analysis of both theories we'll argue that how the "shareholders and Stakeholders interests are compatible and both contribute to corporate long term efficiency and progress."⁴ It will also be analyzed that different countries observing different type of corporate governance models, how much they are able to achieve the purpose of corporations and to protect the stakeholders as whole. How the corporate governance is inevitable to manage the large corporation's transparency which is ultimately crucial to achieve the main purpose of Modern Corporation. We will bring under discussion, two different corporate governance models which have been observed in different countries having diverse historical, political, legal and corporate structural background.

Most of the scholars and researchers are of the opinion that globalization of the world has impact on all aspect of the life, has its immense impact on corporate world as well, it can be analyzed through to some extent convergence of both theories in continental and common law system in result of recent legal reforms in continental as well in common law systems particularly after Enron collapse. The UK has been an exporter of corporate legal concepts and innovations since the inception of corporate norms not only in continental Europe and emerging economies but also around the world. The UK model of corporate governance made standards of corporate governance on which corporate governance of any other market or country can be measured and analyzed. "The ideas developed by the Cadbury Committee⁵ and its successors committees have

³Freeman, *Stakeholder Theory*, 56.

⁴ <http://www.fmb.unimore.it/on-line/Home/Eventi/ConvegniinricordodiMarcoBiagi/documento8375.html> (accessed: May 30, 2014).

⁵ "The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance."

received an ample importance in continental Europe and the rest of the jurisdictions particularly in emerging economies such as China, India, Pakistan and those countries which have old colonial ties with the UK". The variation of the corporate governance structure and arrangement appears in different models but the issue of managerial accountability is common everywhere. We'll also take it under discussion, what are the main reasons behind these legal reforms? Whether globalization of corporate world causing the convergence of theories or it is a case of divergence from one theory to another? In last part of this paper we'll analyze the stakeholder theory in perspective of Pakistani corporate structure with brief description on Code of Corporate Governance. The corporate governance system in Pakistan including the Code of corporate governance is based upon 'shareholders primacy theory' which involves investors in managerial accountability of listed companies through effective and reliable disclosure to maintain good governance of listed companies and long-term market stability. The primary concept of corporate governance is with those who provide capital to the companies and its aim is to improve their returns by providing market stability. However, the political slogan of public-private partnership has become popular without implementation of theoretical dynamics of corporate governance. Therefore, this is the time to formulate the policy of corporate governance that should be competitive for corporate stability and investment. The regulatory authority, policy makers and corporate community should also be clear that the new corporate legal framework in Pakistan should be attractive for the investors as well as provide security to the non-shareholder, stakeholders through services mechanism. The Security Exchange Commission of Pakistan (SECP) is a regulatory body like Financial Services Authority (FSA) in UK and Security Exchange Commission in the USA. The SECP as a 'competent regulatory authority' controls and formulates the framework for the stock exchanges of the country, laid down the listing rules for

listed companies and supervise them. However, it is difficult for the SECP to monitor the governance issues of listed companies on regular basis through effective engagement with the management of the companies.⁶ The significant dimension of corporate governance issues in a developing country like Pakistan, are under developed nature of corporate culture, family dominated business group, regional instability due to war and terror, and ineffective regulatory mechanism. The current Pakistani corporate and ownership structure reveals that the majority of corporations are regulated and controlled by the family groups. It has also been observed that the interest of minorities does not have any consideration during decision making process and there is no corporate framework for protection of their interests.

The Pakistani corporate governance culture is not well established regarding its behavior towards “the actual conduct of corporations in terms of performance, efficiency, growth, financial structure, treatment of shareholders,”⁷ role of institutional shareholders and corporate social responsibility. The Pakistani corporate sector is facing and confronting the issues such as working of board of directors relative to the ownership structure, the responsibility of executive regarding performance of corporation, the functioning of several shareholders including the lack of transparent and accountable financial reporting.⁸ It’s also a matter of concern that corporate structure and its legal framework is always based on one’s historical, cultural, political and legal background, but in case of Pakistan, after its independence the company law was adopted by Common Law system with no major amendments. We are still observing the same in absence of any landmark legal reforms according to our corporate environment. The recent legal reforms in

⁶ R.B Rasul, “Regulatory Impact Assessment of SECP’s Corporate Governance Code in Pakistan” http://www.eastasiaforum.org/testing/eaber/sites/default/files/documents/LUMS_Rais_2005.pdf (accessed March 8, 2013).

⁷ Ibid.

⁸ Ibid

U.K and USA Laws are evidence that they are moving towards shadow convergence and enlightened shareholder primacy by protecting their stakeholders as well. "The experience of these countries underlines the need to adopt coherent regulatory policies with strategic and systemic approaches to build regulatory tools based on enlightened shareholder primacy." The shareholder primacy theory which is implemented in Pakistan is attractive for the investors but it requires active corporate monitoring for which the institutional shareholders can play important role. However, the free and fair functioning of institutional investors requires comprehensive review of their legal framework because the institutional shareholders (such as pension funds, insurance companies, investment companies and unit-trusts) in Pakistan are working under the shadow of federal government. Their functioning should be independent without bureaucratic interference for healthy functioning of major shareholders. However, the stakeholder theory may also be applied to provide job security to the corporate employees through services laws as well as to the general community through consumers' protection laws. The fiduciaries duties of the corporate directors and right of derivative actions for the protection of minority shareholders should also be incorporate in corporate law to protect the investors and to save them from managerial opportunism and agency issues. It will be proved with argument that how the shareholder and stakeholder both are crucial for the stable corporate growth and economy as well, there is dire need to legislate the laws based on stakeholder's protection as whole. The study in this paper provides the critical review of Pakistani corporate structure based on shareholder primacy and explores the dimensions of stakeholder theory with reference to corporate governance, its implementation in Pakistan and its impact on corporate sector. It'll be conclude with recommendations.

1.2. LITERATURE REVIEW:

The idea to maximize the profit of corporation and to protect the investor through protection of stakeholder and implementation of corporate governance model based on convergence of both theories particularly in Pakistan “could not attract large number of researchers. Lack of material poses main hurdle in this study.” The whole material directly related to shareholder and stakeholder theory with reference to corporate governance and convergence of both due to globalization in corporate world is consisting of articles and probably few books which basically deal with theoretical framework of both theories. Few articles books have been discussed in this perspective, in present research.

In this book named as: **Stakeholder Theory: The state of the art.** Written by: **R Edward freeman, Jeffrey S. Harrison:**⁹ authors discuss the different theories related to stakeholders and genesis of these stakeholders theories and also discuss the traditional business, corporate ethics, social and future responsibilities related to stakeholders. In the first chapter of this book particularly the Authors have discussed the genesis of stakeholder theory, its development and the problems stakeholder theory tries to solve. Under the heading of genesis of stakeholder theory the Authors have also focused on the pragmatics and methods this theory and discussed that how this theory can contribute in long term interests of the corporation as whole. The third part of the book contains the comparative analysis of the stakeholder theory and corporate social responsibility whereas further in fourth and last part of book the authors made a detailed discussion about relationship between capitalism and some future possibilities.

In the book titled as “**stakeholders: theory and practice**” written by: **Andrew. L Friedman, Samanth Miles.** The authors define the stakeholders’ theory and its popularity in present

⁹ Freeman, *Stakeholder Theory*, 57.

scenario and discuss the theoretical issues relating to the stakeholders and describe the history and nature of these theories.¹⁰ The theory and its theoretical issues which include history and nature of stakeholder theorizing has also discussed in the book. This book also contains brief discussion about convergence and divergence of stakeholder theory with other corporate theories.

The book entitled as “**Stakeholder theory**” written by **Robert A Phillips** the author critically analyze the perspective of stakeholder theory set by the E. Edward Freeman in his landmark book: “Strategic management: Stakeholder Approach”, and make comparison between CSR and Stakeholder theory. The author also set out arguments by different scholars that although stakeholder theory is not solution to all miseries of corporate world.¹¹

The book entitled as; “**Corporate governance regimes: Convergence and Diversity**” by **Joseph McCahery** the author make assessment regarding contemporary issues of “corporate governance and structure today typically begin at the same point and then diverge.” He also analyzed the theory separation of ownership and control by Berle and Means 1932, according to him when in 1932 “they announced the separation of ownership and control, Berle and Means did not recognize that they are describing a largely Anglo Saxon phenomenon, which did not characterize the corporate systems of most of the rest of the world.”¹² He also critically analyzed the two rival systems of corporate governance exist today first one is dispersed ownership model followed by the shareholder theory, and second one is concentrated ownership model mostly

¹⁰ Andrew L. Friedman and Samantha Miles, *Stakeholders: Theory and Practice: Theory and Practice* (New York: Oxford University Press, 2006).

¹¹ Robert A. Phillips, *Stakeholder Theory: Impacts and Prospects* (Cheltenham: Edward Elgar Publishing Limited, 2011).

¹² J. McCahery, *Corporate governance regimes: convergence and diversity*. (Oxford: Oxford University Press on Demand; 2002), 128.

observing the stakeholder theory. Then in Chapter 4 of this book he has given the argument that how the competition of these two models ultimately force them towards convergence. According to his analysis markets globalization and corporations having very different governance systems based on different theories are compelled to compete head to head, so he has given the detail discussion about two type of convergence which is happening in the corporate world, first one is functional convergence and secondly formal convergence. He put forward his own view on the question that, whether the focal point of that convergence will be a new hybrid governance system comprised of best practices drawn from different systems based on the philosophy of different theories, he is of the opinion that neither the global convergence that eliminates systemic differences nor the convergence of hybrid model because each economy or state has its own integrated system.¹³

In addition to these books many articles have been written on this issue. In this respect, an article entitled "***Stakeholders, Shareholders and Wealth Maximization*** V. Sivarama Krishnan, ***University of Central Oklahoma***" "attempts reconciliation between the two somewhat extreme views espoused by the shareholder wealth maximization paradigm and the stakeholder theory. The stakeholder theory challenges the basic premise built into corporate finance theory, teaching and practice. Corporate finance theory, teaching and the typically recommended practice are all built on the premise that the primary goal of a corporation should be shareholder wealth value maximization. Extant theoretical and empirical research in financial economics also generally accept shareholder wealth maximization as the normative and ideal goal on which all business decisions should be based. This paradigm assumes that there are no externalities and all the

¹³Joseph McCahery et al, *Corporate Governance Regimes: Convergence and Diversity* (New York: Oxford University Press Inc., 2002), 83.

participants engaged in transactions with the firm are voluntary players competing in free, fair and competitive markets. A very different view is offered by what is loosely called stakeholder theory. The stakeholder theory posits that the focus on shareholders and firm value is misplaced and managers should be concerned with all stakeholders of the firm. The paper attempts to address what is felt as a lack of dialogue between the two camps.”

GÉRARD CHARREAUX and PHILIPPE DESBRIÈRES in their article named as “***Corporate Governance: Stakeholder Value Versus Shareholder Value***” “discussed that they are Unsatisfied with the dominating shareholders’ point of view, that appears to be too limited to build a relevant theory of corporate governance, we propose an enlarged definition of the value which may be called, the stakeholder value. This definition and its associated measure are more suitable for the stakeholder approach to the firm and more relevant to understand the value creation and sharing mechanisms.”

In the article titled as “***Deviations from Expected Stakeholder Management, Firm Value, and Corporate Governance***” “it has been investigated that whether and how governance system controls value unrelated stakeholder management. From a practical point of view, in results provide some guidelines for management and boards when dealing with various stakeholders and effectively monitoring management policy regarding stakeholder management.”

In another article titled as “**STAKEHOLDERS VS.SHAREHOLDERS IN CORPORATE GOVERNANCE**” written by **Alberto Chilosi and Mirella Damiani**, they have discussed the two alternative concept of the corporate governance based on two opposite theories. They have divided, research paper in two parts, “first considers in general the issue of stockholders vs. stakeholders oriented governance systems and their relative merits and demerits. The second part

deals specifically with the issue of the principal-agent problem in a stakeholder context". It's a kind of quantitative research in which they have analyzed that, corporate governance model based on appropriate theory can alleviate the agency problem.¹⁴

James Kirkbride Steve Letza and Xiuping Sun in their article named as "Shareholding Versus Stake holding: a critical review of corporate governance" are of the opinion that "current debate and theorizing on corporate governance has been polarized between a shareholder perspective and a stakeholder perspective."¹⁵ While advocates and supporters of each camp attempt to justify the superiority, rationality and universality of each model in theory, they rarely pay attention to the age-old conceptions, assumptions and presupposition underpinning their perspectives which are less credible and valid in matching the continually changing practice of corporate governance.

This paper serves as a survey and critical review of major current theories on corporate governance. In so doing, it reveals the inadequacy of conventional approaches employed in corporate governance theorizing. It calls for a new mode of thinking in analyzing corporate governance and concludes by outlining a new direction of research in this field.¹⁶

Another Article named as "Shareholder Vs Stakeholder" written by N. Craig Smith and David Ronnegard, they are of the opinion that "Liberalism and libertarianism can be interpreted to justify shareholder and stakeholder theory respectively."¹⁷ In this research paper they also argued that political theory have also play vital role in the ethics and governance of Corporations as

¹⁴ Mirella, Alberto Chilos, "Damiani Stakeholders vs. Shareholders in Corporate Governance" http://mpra.ub.uni-muenchen.de/2334/1/MPRA_paper_2334.pdf (accessed May 5, 2013).

¹⁵ Steve Letz, Xiuping Sun and James Kirkbride. "Shareholding Versus Stake Holding: A Critical Review of Corporate Governance." *Corporate Governance* 12 (2004): 242-262.

¹⁶ Ibid.

¹⁷ David Ronnegard and N. Craig Smith, "Shareholders vs. Stakeholders: How Liberal and Libertarian Political Philosophy Frames the Basic Debate in Business Ethics," *INSEAD Faculty & Research Working Papers* (2011).

corporations resembles to a state. They also analyzed that the normative, descriptive, and instrumental arguments put forwarded by both side, how much these are affective to prove their instance regarding corporate governance.¹⁸

The text of these books and articles provide understanding the changing pattern of relationship between different corporate governance theories particularly stakeholder and shareholder theory. Yet there is not enough data about stakeholder model implications regarding Pakistan. Thus, in this dissertation an attempt to fill the gaps that have been left behind in area of research, will be discussed.

1.3. THESIS STATEMENT:

“Hybrid model of corporate governance based on two opposite shareholder and stakeholder theory could lead to increase financial performance of corporations as whole and its implementation in Pakistan would be suitable to the indigenous corporate culture and structure.”

1.4. HYPOTHESIS:

Now the scenario of the corporate world has changed we need to change the pragmatist approach that runs throughout in corporate governance. The stakeholder theory can alleviate the problems of value creation and trade, ethics of capitalism, managerial mindset and agency problem, it can bring the long term stability in corporate security market and it is beneficial to investors as well as economy. It is a more useful way of understanding modern capitalism.

1.5. OBJECT OF STUDY:

¹⁸ David Ronnegard and N. Craig Smith. “Shareholders vs. Stakeholders: How Liberal and Libertarian Political Philosophy Frames the Basic Debate in Business Ethics”. *Business and Professional Ethics Journal* 32 (2013) 183-220.

The object of research is to consider in general the issue of shareholders vs. stakeholders oriented governance systems and their relative merits and demerits and also to explore that whether all stakeholders are critical in creation of firm value. On the basis of this research suggestions would be made regarding the best suited framework based on appropriate theory for Pakistani corporate governance system.

1.6. RESEARCH RELATED QUESTIONS:

- 1) What is the difference between shareholders and non-shareholder stakeholders?
- 2) Who have primary right in corporation and who have secondary right?
- 3) How can we categorize the active stakeholders and non-active stakeholders?
- 4) Which should have right to influence key decisions of company in corporate governance?
- 5) In whose favor company should run either shareholder or stakeholder?
- 6) How can we achieve the purpose of firm to maximize the wealth either by shareholder or stakeholder theory?
- 7) Can we achieve maximize value sustainability by neglecting a stakeholders interests?
- 8) What is the major differences in both shareholder and stakeholder theories?
- 9) Why shareholder theory has failed to stable the security market and economy?
- 10) How can we protect the primary stakeholders although all legislation is made for the protection of investors?
- 11) Can we implement both theories simultaneously?
- 12) Why stakeholder theory rapidly emerged after Enron scandals in 2000's?
- 13) What are the causes behind it?
- 14) Whether globalization of corporate world is causing the convergence of both theories?

- 15) The recent legal reforms in UK and US corporate law are evidence of convergence or divergence of two opposite theories. Is it?
- 16) Which theory is best suited for legal framework of Pakistani corporate sector?
- 17) Whether Pakistani corporate sector is also influenced by globalization of corporate world?

1.7. JUSTIFICATION OF THE STUDY:

From the literature which has been reviewed it has been realized that a lot of work has been done for the implementation of right corporate theory in the international corporate governance perspective particularly after the Enron and other economy collapses all over the world, it is essential to work in a new international order to find out the implications of stakeholder model or shareholder enlightened theory model in Pakistan. The growing relationship between two opposite theories through convergence holds immense significance for Pakistani corporate sector and its economy. The convergence or divergence of two corporate models and corporate globalization will surely affect corporate sector of Pakistan. That's why the issue needs proper consideration, so, it would be analyzed in various dimensions.

1.8. RESEARCH METHODOLOGY:

It is comparative oriented research work. Qualitative research method is used in order to conduct research including law books, economics books, articles, journals, newspapers, libraries, scholar speeches and internet sources. This study of research follows the three elementary mechanisms of research, i.e. description, analysis and prescription. This research will be conducted in an analytical and contemporary perspective. The all issues related to the subject would be analyzed to evaluate the shareholder and stakeholder theory in reference to corporate governance. "The

company law and other legislation, text of legal reforms will be used as primary source whereas the secondary source material will include books, scholarly research, journal articles, and literature available on net and accessible official documents".

1.9. ORGANIZATION OF STUDY:

For better understanding and comprehensive analysis, the study will be divided into five Chapters.

First chapter is an introduction to the research paper. It focuses on the significance and objective of the subject. Key questions will also be addressed in this chapter. It also comprises the literature review and layout plan of the study. The second chapter titled as "Theoretical framework of the Shareholder and Stakeholder theory" will discuss the both theories in detail. This chapter will help in analyzing the nature of two opposite theories and its characteristics. It will also focus on the difference between them as well as the similarities. This part of thesis presents the theoretical framework; begin with theoretical view of shareholder capitalism then move on to ethical theory and corporate social responsibility and this naturally leads to introduction of stakeholder theory. Third Chapter will give a detailed account of different corporate governance models based on these two opposite theories it would be discussed in terms of their merits and demerits. The aim is to analyze these models in shareholder and stakeholder perspective.

Fourth Chapter will analyze the convergence of these two theories regarding corporate governance in context of recent worldwide corporate legal reforms.

Fifth chapter will be based on Pakistan case study and conclusion in which whole research work will be analyzed and recommendations would be given with perspective of stakeholder theory in relation to Pakistani corporate structure.

CHAPTER 2:

THEORETICAL FRAMEWORK OF SHAREHOLDER AND STAKEHOLDER THEORY

2.1. INTRODUCTION:

Corporate governance system is concerned with need to govern and manage the corporations. The corporate governance systems include and describe the techniques that can be used to protect the interests of those that provide the resources essential to the operations of corporation. Corporate governance models in different countries are based on two opposite approaches either on Anglo American approach or European continental approach. This chapter comprises the theoretical framework of these two different approaches. It describes the shareholder capitalism including discussion beyond shareholder capitalism such as ethics, morality and corporate social responsibility which ultimately leads to the theoretical prototype of stakeholder theory. There are little direct divergence between the shareholder view and stakeholder view. The stakeholder theory suggest that if we take on as a unit of analysis the relationship between a corporation and individuals who can affect or are affected by it then we have better chance to deal with these problems which occurred in the implementation of shareholder theory in corporate governance. For this reason the identification of stakeholders are very critical. This chapter also contain the discussion about identification of stakeholders those are crucial for corporation's survival their classification including ranking of salience.

2.2. SHAREHOLDER THEORY:

Common law system is obvious paradigm of shareholder capitalism based on shareholder theory. The source of shareholder theory is classical economic theory. The 20th century was milestone in

promotion of shareholder theory as it was largely promoted through the work of Milton Friedman; Milton Friedman is greatest proponents of shareholder theory. Friedman continuously campaigned for dictum that the only obligation of company is to create and maximize the profit for its owners/shareholders. Friedman's opinion regarding responsibility of a company can be best described in his own words:

There is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception and fraud.¹⁹

According to advocates of shareholder theory morality and ethics do not have any affair with creation of value and its trade. They further elaborated that ethics and principles are side constraint because managers are expected to hold back themselves from scam and deception. The advocates of shareholder theory believe that the key objective of company is to maximize the wealth of shareholder and any other activity which comes under the ambit of social responsibility can divert the management from primary goal.²⁰ Ultimately they give high regard to the supremacy of shareholders by protecting their interest in any case.

The notion or resolution of shareholder theory is that the corporations have a principle responsibility towards their shareholders which bound them to maximize the wealth of shareholders.²¹ This notion categorically depicts that shareholders are supposed to maximize their own wealth. If management takes any action or formulates any policy which does not result in maximization of wealth of shareholder, this situation will lead to occurrence of agency

¹⁹Thomas Pedersen, *Stakeholder Theory, lesson from Denmark* <http://pure.au.dk/portal-asb-student/files/2259/000128655-128655.pdf> (accessed October 15, 2011).

²⁰R. Edward Freeman, Kirsten Martin, and Bidhan Parmar. "Stakeholder Capitalism." *Journal of Business Ethics*, 74(2007): 303-314.

²¹Casey Reader, How Contributor, "Stockholder Theory vs. Stakeholder Theory"
http://www.ehow.com/info_8483188_stockholder-theory-vs-stakeholder-theory.html (accessed October 10, 2011).

problem.²² Agency problem always occurred due to the conflict of interest between shareholders and management. Principle agent problem occurred when management fails to work in the best interest of shareholders.

Jensen a well-known proponent of shareholder supremacy emphasizes that “management should only focus on maximizing the total value of the company. He argues that for management to be effective, the objective function of the company must contain only one objective”²³ because more than one objective will require making choice between the competing interests or prioritizing. In above said situation if management has more than one objective then “management will not be able to make balance decisions in these two opposite situation efficiently, thus preventing them from making purposeful decisions.”²⁴ Jensen also advocate the enlightened value maximization, it is interesting development put forward by him we will discuss it later.

The shareholder approach is “logically most compatible with Anglo-American corporate modal.”²⁵ Corporate law in the US and UK, comprising both “common law and statutory law, is structured to ensure that corporations work in the interest of shareholders.”²⁶ Shareholder primacy is a development of common law and debate about its effectiveness and legitimacy is developing from judicial decisions. Common-law provides the “clearest articulation of shareholder primacy in the court cases describing that managers and directors have fiduciary

²² Pedersen, *Stakeholder Theory*, 34.

²³ V. Sivarama Krishnan, “Stakeholders, Shareholders and Wealth Maximization”(University of Central Oklahoma), <http://www.abe.sju.edu/proc2009/krishnan.pdf> (accessed October 14, 2011).

²⁴ Ibid.

²⁵ A. C. Fernando, *Corporate Governance: Principles, Policies and Practices* (Indiana: Dorling Kindersley, 2006).

²⁶ http://www.hetecon.net/documents/ConferencePapers/2011Non-Refereed/Lee_AHE_2011043P.pdf (accessed: January 19, 2015).

duties to shareholders”²⁷ and must take decisions that are in their best interests. The most famous articulation of shareholder supremacy comes from the 1919 case of “Dodge v. Ford Motor Co”²⁸ wherein Chief Justice Ostrander said:

A business corporation is organized 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 shareholders in order to devote them to other purposes.²⁹

According to this theory directors are bound by fiduciary duty of care and loyalty in favor of shareholders while taking decisions. The condition of loyalty requires that they will promote the interest of Shareholders observing the duty of care in a manner that they will not put themselves in a position so that their interest might conflict with them.³⁰ The advocates of shareholder theory indicate that it is impracticable to promote and protect the interest of all stakeholders due to conflicting interests of stakeholders.³¹

It is also important that many of the economist and theorist do not consider that the sole responsibility of company is only to protect the interest of shareholders, they believe that consideration should be given to the other relevant stakeholders also, which includes customers, consumers, employees, environment etc. That alleged that corporate governance modal based on shareholder capitalism fails to sustain the corporation long term profitability.

²⁷ <http://www.insead.edu/facultyresearch/research/doc.cfm?did=52943> (accessed: January 10, 2016).

²⁸ David Ronnegard and N. Craig Smith, “Corporate Social Responsibility and the Legitimacy of the Shareholder Primacy Norm” *published by INSEAD*, (2010). <http://ssrn.com/abstract=1532225> (accessed November 10. 2011).

²⁹ Ibid.

³⁰ Ibid.

³¹ Bradley W. Benson and Wallace N. Davidson III, “The Relation between Stakeholder Management, CEO Compensation, and Firm Value: A Test of Enlightened Value Maximization,” *Financial Management* 39 (2010): 929-963.

2.3. **BEYOND THE SHAREHOLDER CAPITALISM:**

It is also worth important that what can be beyond the Shareholder capitalism. There is Continental European Approach introducing corporate modal based on stakeholder theory it's totally opposite to the Anglo-American Approach which is discussed in previous heading. The approach of shareholder capitalism is opposite to the stakeholder capitalism which incorporates the morality and social responsibility in it. The stakeholder capitalism shifts the focus on long term interest of all parties ultimately achieving the goal of firm. The customary theories of ethics and morality as well as the notion of corporate social responsibility are incorporated in working of management. Consequently, this perspective of governance activates the emergence of stakeholder theory.³²

2.3.1. **ETHICS AND MORALITY:**

European approach differs from Anglo Saxon on the point that it is based on the notion of ethics and morality but it's essential to differentiate terms of Ethics and Morality. Scholars define morality is related to the existing social practices which described the right and wrong.³³ Morality is a Doctrine or system concerned with conduct of people in society.³⁴

What defines the ethics? "The ethics relate to the set of rules, principles, or ways of thinking that guide, or claim authority to guide, the actions of a particular group; and sometimes it stands for the systematic study of reasoning about how we ought to act."³⁵ There is slight difference between ethics and morality as the ethics defines the social system whereas, the morality deals with personal conduct or character of any person. In other words, ethics spotlight the personal

³²Pedersen, *Stakeholder Theory*,

³³Ibid.

³⁴John Deigh, "Ethics vs. morals and morality," <http://www.philosophyblog.com.au/ethics-vs-morality-the-distinction-between-ethics-and-morals/> (accessed October 16, 2011).

³⁵Ibid.

reflection of morality in society. The ethics provide a social system in which principles of morality applied. In other words, “ethics point to standards or codes of behavior expected by the group to which the individual belongs.”³⁶ According to the scholars, generally the word “ethics” is used as a general term to mention the beliefs of society and ethical theories. The standards or principles recognized or created by the society or culture are called morality and it is not compulsory whether the morality is accepted by the individual (company) or not. However, the ethics can be described as moral standards that are accepted and practiced by the individual of the society. “Ethics thus incorporates morality”.³⁷

1.3.2. ETHICS AND LAW:

A well-known scholar Friedman explained that the corporations cannot involve in any improper business if they are working within the limits of law. However, “it is important to note that if something is legal it is not necessarily ethical, meanwhile, if something is illegal it is not necessarily unethical.”³⁸ The law can be defined as reliable, universal, published, accepted and enforced, the other hand ethics cannot be compelled *and enforced or it is not necessary for ethics to be universal or published.* The factor of compulsion or enforceability make vital difference between ethics and law, to do any act within the limits of ethics is totally depended on the discretion of any individual. But to obey the law is not discretion of individual.³⁹ The legislator always try to make the law according to the parameters described by the ethics but still it is also impossible to avoid the circumstances where grey area exists. Therefore, “In certain circumstances the law is not enough to make individuals and corporations behave ethically.” It is

³⁶“What is the difference between ethics and morals”

<http://www.wisegeek.com/what-is-the-difference-between-ethics-and-morals.htm> (accessed October 15, 2011).

³⁷Pedersen, *Stakeholder Theory*, 54.

³⁸Pedersen, *Stakeholder Theory*, 54.

³⁹Aron, “Difference between laws and ethics,”

<http://www.differencebetween.com/difference-between-law-and-ethics/> (accessed October 15, 2011).

also pertinent to note that the acts of individuals who are based on their conscience do not observe the definition of ethics. It is possibility that the act taken by individual with his conscience does not come under the criteria of morality and ethics what society deems to be correct. This also is relevant to a specific group such as the shareholders of a company, as what they believe to be right "(i.e. the notion that the sole responsibility of the company is to maximize their wealth) is not acceptable by the rest of the society."⁴⁰

2.3.4. CORPORATE SOCIAL RESPONSIBILITY:

Corporate social responsibility emerges from the perception of business ethics which defines the issues of right and wrong. The area defined by the proponents of CSR covers extensive variety of issues such as "employee relations, human rights, corporate ethics, community relations and the environment."⁴¹ Corporate Social responsibility has very impressive history regarding its evolution, concept and definition. We can trace back the evolution of the CSR in 1950's which also called as modern era of CSR. Definitions expanded during the 1960s by the work of different writers like Keith Davis, Joseph W. McGuire and it increases greatly and suddenly in a number during 1970's. A jurist known as Bowen set forth an initial definition of the social responsibilities of businessmen: "It refers to the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society".⁴² Whereas in 1963 Joseph W. McGuire had gave another definition he stated "The idea of social responsibilities supposes that the corporation has

⁴⁰ Pedersen, *Stakeholder Theory*,

⁴¹ Lance Moir, "What do we mean by corporate social responsibility?" *Corporate Governance: The international journal of business in society* 1 (2001): 16-22.

⁴² Archie B. Carroll, "Corporate Social Responsibility: Evolution of a Definitional Construct," *Business Society* 38 (1999): 268-295.

not only economic and legal obligations but also certain responsibilities to society which extend beyond these obligations”⁴³

The Green paper in 2001 and “communication in 2002 issued by the European Commission set outs its strategy for the definition, concepts, benchmarking experiences, pooling of approaches, and development of a CSR framework at the European level.”⁴⁴ A one definition given by the European Commission is following;

A concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.⁴⁵

The European Union defines CSR as a program in which “companies decide voluntarily to contribute to a better society and a cleaner environment”.⁴⁶ A Green’s paper on CSR issued by European Commission (2001) specifies the key word “Voluntary” in its quote. Therefore, social responsibility of corporation is more than mere compliance of the law. The number of reasons has been referred by the European commission for the increased emphasis on CSR. These reasons incorporates the increasing company size, growing awareness and concern about environment, swelling transparency in corporation, and rising apprehensions from various stakeholders. The commission acknowledged the notion of shareholder theory that only purpose of corporation is to maximize the value of owners but further explains that the corporations who

⁴³ Ibid

⁴⁴ Lorenzo Sacconi, “Corporate social responsibility (CRS) as a model of “Extended” corporate governance. An explanation based on the economic theories of social contract, reputation and reciprocal conformism,” <http://www.biblio.liuc.it/liucpap/pdf/142.pdf> (accessed January 1, 2012).

⁴⁵ Pedersen, *Stakeholder Theory*,

⁴⁶ Geoffrey M. Heal, “Corporate Social Responsibility-An Economic and Financial Framework” http://papers.ssrn.com/sol3/papers.cfm?abstract_id=642762 (accessed January 1, 2012).

achieve this goal can also contribute positively in society.⁴⁷ The corporations are legally bound and under compulsion to obey the law but to follow the ethics and ethical code is its discretion. In other words, the socially responsible firms exercise its discretionary power.⁴⁸ The CSR comprises on four types of social responsibilities economic, legal, ethical, and philanthropic. In contemporary corporate culture the ethical and philanthropic (charitable) tasks have taken important place.⁴⁹ In this modern era the corporations are allocating immense resources for happening of activities which come under the definition of CSR. Ultimately, they are achieving the goal of corporation by increasing its good will. However, the corporations can harmonize the expenditure of CSR with value creation of owners if it categorize and prioritize the stakeholders.⁵⁰

Now the question is whether the “socially responsible firms achieve higher, lower, or similar levels of financial performance”⁵¹ than firms that do not meet the same CSR criteria.”⁵² How we can determine existing relation between social responsibility and corporate economic performance whether it’s positive or negative. There are a number of empirical research has been conducted in the past to test this relation. Existing empirical papers can be categorized into three groups with some calculation. The first group discovers the positive or certain relationship between CSR and corporate performance and functioning. It has been analyzed that the expenses

⁴⁷ Leonardo Becchetti, Stefania Di Giacomo, and Damiano Pinnacchio, “Corporate Social Responsibility and corporate performance: evidence from a panel of US listed companies,” Research Paper Series, 26 <http://papers.ssrn.com/abstract=871402> (accessed January 2, 2012).

⁴⁸ Pedersen, *Stakeholder Theory*,.....

⁴⁹ Archie B. Carroll, “The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders,” *Business Horizons* (1991) 1-20.

⁵⁰ Amir Barnea and Amir Rubin, “Corporate Social Responsibility as a Conflict between Shareholders” <http://apps.olin.wustl.edu/jfi/pdf/csr.conflict.pdf> (accessed January 2, 2012).

⁵¹ Financial performance is typically defined in such studies in terms of either (short- or long-run) stock prices or accounting profitability (e.g., return on equity, return on investment, or operating profit).

⁵² Catherine J. Morrison Paul and Donald S. Siegel “Corporate Social Responsibility and Economic Performance,” http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900838 (accessed January 2, 2012).

incurred upon aptitude of CSR are reimbursed by achieving the employee morale, efficiency, output and productivity. The positive relationship between CSR and financial performance of corporation has also been observed. However, the second group of empirical researchers does not find any suggestive direction regarding any connection between CSR and corporate performance. A third group finds out a negative relationship and consider that social responsibility affect the primary goal of the firm.⁵³

In the U.K., there is a minister for CSR and in its second report on CSR, published in 2002, the Department of Trade and Industry states: "The Government has an ambitious vision for corporate social responsibility: to see private, voluntary and public sector organizations in the U.K. take account of their economic, social and environmental impacts, and take complementary action to address key challenges based on their core competences locally, regionally, nationally and internationally."⁵⁴

There are different theories to analyze and explain corporate social responsibility for instance Stakeholder theory, legitimacy theory,⁵⁵ and social contract theory⁵⁶. But in this thesis our focus is on stakeholder theory including shareholder theory and we'll discuss that the corporate governance model based on which theory can be more beneficial and helpful to achieve the primary goal of corporations.

⁵³ Beccetti. Et al, "Corporate Social Responsibility and corporate performance, 23.

⁵⁴ N. Craig Smith, "Corporate social responsibility: not whether but how?"

<http://www.london.edu/facultyandresearch/research/docs/03-701.pdf> (accessed January 2, 2012).

⁵⁵ Suchman (1995) defines legitimacy as "a generalized 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".

⁵⁶ Donaldson and Dunfee (1999) develop integrated social contracts theory as a way for managers to take decisions in an ethical context.

2.4. STAKEHOLDER THEORY:

In above discussion we traced out the origin of stakeholder theory by giving an overview of ethics in general, ethics in business and CSR to a management approach. Stakeholder theory relates to the managerial approach about business and corporation. “It asserts that business can be understood as a set of relationship among groups which have stake in the activities in business.”⁵⁷ In this perspective the stakeholder theory attempts to give mechanism for implementation of ethics and CSR in the corporation or business, in other words it gives extension to the notion of CSR.⁵⁸ The word “stakeholder” is used to describe those groups who can affect, who are affected by, the activities of the firm.⁵⁹ The origin of ‘stakeholder’ can be traced back to 1963, when the word appeared in an international memorandum at the Stanford Research Institute. Stakeholders were defined as “*those groups without whose support the organization would cease to exist*”. This have core concept that the firm will not survive without the support of these key groups. Scholars in the stakeholder field differ “in their view on stakeholder concepts, but most of them acknowledge Freeman’s book *Strategic Management: A Stakeholder Approach*” as a landmark in stakeholder literature.” In this book “Edward Freeman’s set forth a new method and set of techniques for executives to use to better understand how to manage key stakeholder relationship.”⁶⁰ After this book, “this literature developed around three different aspects namely, descriptive/empirical aspect, instrumental aspect and normative aspect.”⁶¹

⁵⁷ Wayne Visser, et al, *The A to Z of Corporate Social Responsibility* (Wiltshire: Antony Rowe Ltd, 2010),....

⁵⁸ Pedersen, *Stakeholder Theory*,

⁵⁹ Thomas M. Jones, Andrew C. Wicks and R. Edward Freeman , “Stakeholder Theory: The State of the Art”http://www.blackwellpublishing.com/content/BPL_Images/Content_store/Sample_chapter/0631221220%5Cbowie.pdf (accessed January 3, 2012).

⁶⁰ Visser, *The A to Z of Corporate Social Responsibility*,

⁶¹ Arun A. Elias and Robert Y. Cavana, “Stakeholder Analysis for Systems Thinking and Modeling” (New Zealand: Cavana School of Business and Public Management Victoria University of Wellington) Available at <<http://portals.wi.wur.nl/files/docs/ppme/BobCavana.pdf>> (last accessed: January 3, 2012)

2.4.1. EMERGENCE OF STAKEHOLDER SOCIETY:

According to Freeman the view of the corporation developed overtime. The growth or advancement of corporations has been traced out from simplistic view to more complex one and finally to the stakeholder view. The production view is referred as leading and most simple view which describes the stage of business on which simply raw materials is obtained and converted into products. The said products are placed in market for sale to customers.

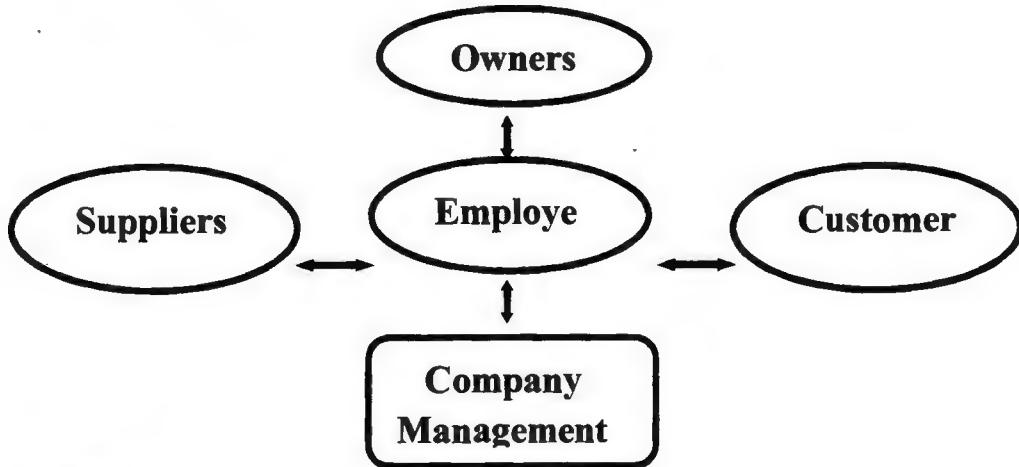
Figure 1: Constructive view of company



The set up based on this view still exist in small enterprises mostly in family owned companies, they may have grown in size but their perception of workload has not changed still. Freeman refers second view as managerial view, which includes many players like owners, employees, suppliers and customers, after the emergence of new interest groups due to the changing of environment and firm view became more complex than ever. The major factor involved in the evolution of managerial view was emergence of the theory separation of ownership and control including increasing influence of the workforce. The modal based on this view was more complex in the sense that more players and due to their mutual relationship (see figure 2). Consequently, more interaction occurs among the different groups.⁶²

⁶²Pedersen, *Stakeholder Theory*,.....

Figure 2: Managerial view of the Company



Source: Freeman

In view of the Freeman the corporations can't be successful by following the managerial view of business as there are other key factors other than owners, suppliers, customers and employees that are playing vital role for the success of corporations. Freeman defines the term stakeholders as follows:

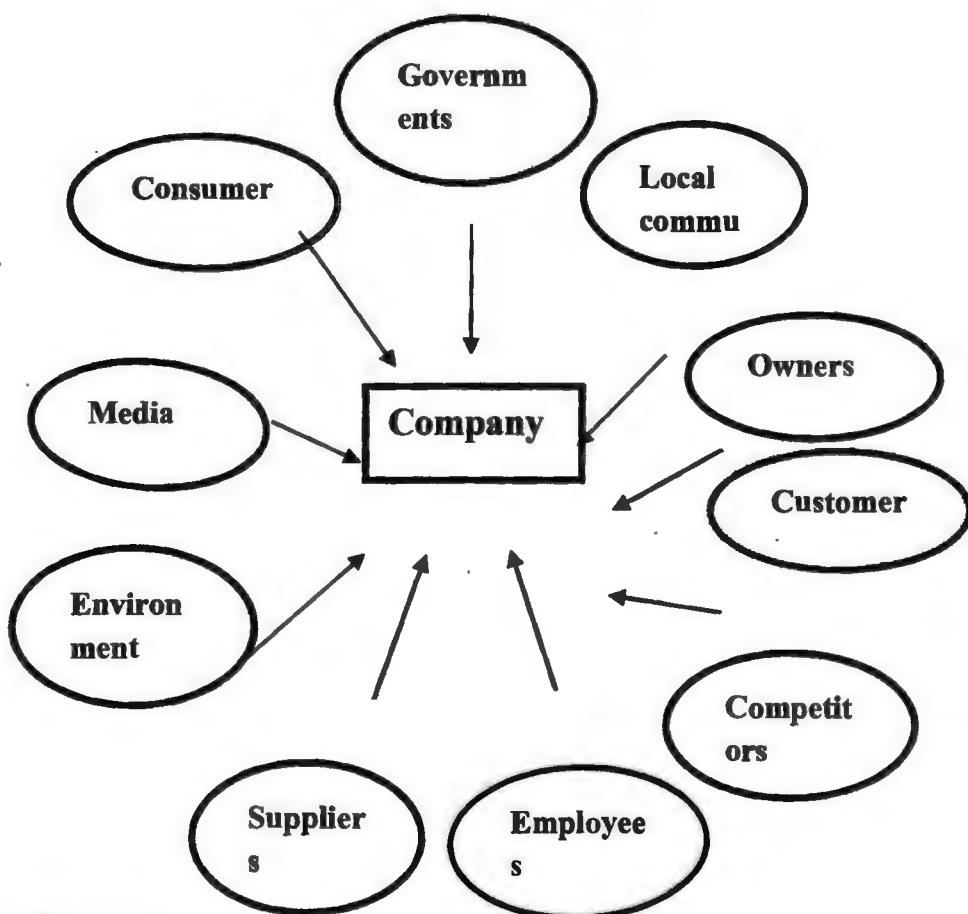
“A stakeholder in an organization is any group or individual who can affect or affected by the achievements of organization’s objectives”⁶³

According to well-known jurists Edward freeman and Donaldson and Preston the person or group of persons have any interest or stake in the corporation can be barely labeled as stakeholders. Other than the four groups of the managerial view as mentioned above there are many other players or actors like media, consumer, advocates, competitors, environmentalists who do not have any direct interest in corporation but still they might influence the business or

⁶³ Locas Rangeler, *CSR & Organizational Identification: To Which Extent Do CSR Initiatives achieve organizational ethics* (Norderstedt: GRIN Verlag, 2009) 13.

corporation. However, the Freeman only gives emphasis on the stakeholders that are critical for the survival and financial performance of corporation. Therefore, this view opposes the broader view of stakeholders.⁶⁴ (See figure 3).

Figure 3: Stakeholder view of Company:



Source: Freeman

The Stakeholders mentioned in figure 3 some of them are more important in short term while others are may only matter in long term interest of corporation and rarely affect the action of the managers. Stakeholder management has become important, since manager have discovered that many stakeholders ought to be satisfied in order to meet the company's objectives. As each

⁶⁴Joachim Schwalbach, *Corporate Social Responsibility and Stakeholder Dynamics* (Norderstedt: Gabler Verlag, 2010), 43.

stakeholder pursues different interests which mutually influence each other, the challenging task is therefore, to balance in between the area of diverse interest. For this reason It must be specified by each firm that “who are its stakeholder”. There have been different approaches put forward to classify the stakeholders groups or classes. The Clarkson categorized the stakeholders as primary stakeholders and secondary stakeholders. The stakeholders whose ongoing contribution and participation is crucial for survival of corporation are called primary stakeholders. Whereas, secondary stakeholders only matter for long term interests of the corporations and the survival of corporations is not dependent upon them.⁶⁵ Freeman further claims that the corporation can built healthy relationship with all stakeholders by somewhat protecting the interest of all groups. It may not result into short term benefits but it can be crucial for long term benefits and existence of the company. Jensen also advocates the enlightened value maximization which elaborates that corporations can protect their long term interest by considering the interest of various stakeholder groups. Freeman also argues that corporation should be ethical to the stakeholders, it's ultimately benefiting the corporation in many ways, and corporations should do this act voluntarily, without the intervention of the legislative power.⁶⁶

2.4.2. STAKEHOLDER THEORY AND PROPERTY RIGHTS:

Stakeholder theory further explains the ideology of property rights in connection with corporations. Instead of the traditional view of shareholder theory that claims all profit entitlement goes to owners, the stakeholder theory justify the right of all concerned parties. Donaldson and Preston also provide moral foundation, on which theory base. In their view property right theory can provide such a basis since the several authors from the field see the right of private property extends beyond the rights of owners. Modern property right theory not

⁶⁵ Rangeler, *CSR & Organizational Identification*,.....

⁶⁶ Pedersen, “*Stakeholder Theory*”,

only provides unlimited property rights to owners but also make clear that attention has to be paid to the non-shareholders.⁶⁷ In view of the scholars the rights of employees towards their labor, the rights of customers towards their wealth and the rights of communities towards their public goods should be respected. In the same way they argue that it is again obvious that a company must respect the individual stakeholder's property rights".⁶⁸ There is Pluralistic theory of property rights which further clarify the connection between property rights theory and stakeholder theory; it clearly shows that protecting the rights of property not only allows, but actually requires the protection of the interest of all stakeholders.⁶⁹

2.5. STAKEHOLDER IDENTIFICATION:

Several attempts were made to identify and differentiate stakeholder groups. The basic question remains as how we can manage different stakeholders with different needs and demands, does stakeholder theory provide a clear guideline to deal with various stakeholders. As the organization is unlikely to please and protect all stakeholders in an even way, a strategic response is required to balance and prioritize the demands by diverse stakeholders.⁷⁰

The term stakeholder broadly incorporates any person or group of individuals whose interest or actions are even remotely affected by the company. On the other hand some scholars only acknowledge a limited group in definition of stakeholders such as shareholders, customers and employees. However, it is very crucial to formulate the process through which the legitimate stakeholders can be differentiated from illegitimate. The scholars namely Mitchell, Agle &

⁶⁷ Jens Hillebrand, *Stakeholder Management in Small and Medium-Sized Enterprises* (Belgium: Grin, 2010), 29.

⁶⁸ Pedersen, "Stakeholder Theory,.....

⁶⁹ Wanjiru Njoya, *Property in Work: The Employment Relationship in the Anglo-American Firm* (Hampshire: Ashgate Publishing Limited, 2007),.....

⁷⁰ Zahirul Hoque, *Methodological Issues in Accounting Research: Theories, Methods and Issues* (London: Spiramus Press Ltd, 2006), 211.

Wood have given the narrow definition of stakeholders by considering that only those persons are stakeholders who have any direct financial interest towards corporation..⁷¹

Friedman and Miles identify fifty five definitions for stakeholders that vary on two factors. One is whether the definition perceives stakeholders as strategic through achievement of the corporation's objectives or solely based on socially recognized norms. The other factor is whether the definition is broad to include all entities or narrow to only those stakeholders critical for firm's survival.⁷² Legitimacy based definition of stakeholder recommend to only treat to those entities as stakeholders who have some form of legitimacy. Thereby this legitimacy can take many forms, a contractual relationship, and participation in the corporation's wealth maximization process, property right, risk beard or a moral right.⁷³

The certain scholars attempted to divide the stakeholders into two categories as primary and secondary stakeholders. They prioritize the primary stakeholders on basis that are they are critical for the survival of the corporation. On the other hand the secondary stakeholders are not devoted to the corporation on transactional basis and are not considered critical for the survival of the corporation.⁷⁴ Identification of stakeholders is central to successful stakeholder management, defined as the development and implementation of organizational policies and procedures that consider the goals and concerns of all stakeholders.⁷⁵

2.6. STAKEHOLDER IDENTIFICATION TYPOLOGY AND RANKING OF SALIENCE:

⁷¹ Pedersen, *Stakeholder Theory*,.....

⁷² Tracy L. Gonzalez-Padron, *Turning Corporate Social Responsibility into Opportunity* (Ann Arbor: ProQuest LLC, 2008), 28.

⁷³ Marc Maurer, *Corporate Stakeholder Responsiveness: An Evolutionary and Learning Approach* (Berne: Haupt Berne, 2007), 64.

⁷⁴ Hoque, *Methodological Issues in Accounting Research: Theories, Methods and Issues*, 211.

⁷⁵ Padron, *Turning Corporate Social Responsibility into Opportunity*, 28.

There is very little research available on how to identify the stakeholders that are truly crucial to be considered during financial decisions of corporation which ultimately affect them. Some scholars namely Harrison & Freeman and Mitchell, Agle & Wood have very significant contributions by their work regarding identification of stakeholders.⁷⁶ Mitchell et al argued that stakeholder theory offers, “*a maddening variety of signals on how question of stakeholder identification might be answered*”.⁷⁷ Mitchell, Agle & Wood suggest the three new classes of stakeholders by using Freeman’s broad definition of stakeholders. According to which stakeholders can be identified on three bases, power to influence the corporation, legitimacy of relationship and urgency of stakeholder’s claim. These three classes of power, legitimacy and urgency contribute to the conception that the extent of possession of these characteristics by stakeholders is a function of their level of significance.⁷⁸ Legitimacy reflects the extent to which a meticulous claim is respected, logically inferable and given social acceptance and value by respondents. Legitimacy can be attained over the short or long term, although it is recognized that legitimacy is created at an individual, organizational or social level.⁷⁹

The claim of legitimate stakeholders emerges from contractual or legal obligation Legitimacy can be referred as moral right of stakeholders which can be asserted by them.⁸⁰ “A stakeholder has legitimacy when its actions toward the corporation are desirable or proper within the norm, values and beliefs of the larger society. Power refers to the degree that a stakeholder can impose

⁷⁶Pedersen, *Stakeholder Theory*,.....

⁷⁷Michael Jay Polonsky, “Stakeholder Thinking in Marketing.” European Journal of Marketing 39 (2005), 1065.

⁷⁸Alan R. Nankervis, *Managing Services* (Cambridge: Cambridge University Press, 2005), 79.

⁷⁹Cummings, *Managerial Attitudes toward a Stakeholder Prominence within a Southeast Asia*, 54.

⁸⁰Samuel O. Idowu and Walter Leal Filho, *Professionals' Perspectives of Corporate Social Responsibility* (London: Springer 2009), 79.

its will in its relationship with the corporation.”⁸¹ A legitimate stakeholder is however not always powerful, while a powerful stakeholder is not always legitimate.

“The third class is urgency, urgency is based on two elements, and first one is time sensitivity, the degree to which managerial delay in attending to the claim or relationship is unacceptable to the stakeholders. The second one is criticality, the importance of the claim or the relationship to the stakeholder. Power alone is insufficient for classifying a stakeholder’ priority, legitimacy is required to provide authority and the urgency is requisite for execution. All attributes are temporary; they can be gained as well as lost. A party must be apparent by management to possess at least one attribute to be acknowledged as stakeholder.”⁸²

It is proposed that attention paid to certain stakeholder depend on the possession of one or two or all of three attributes power, legitimacy and urgency. Stakeholder having one of the three attributes will obtain low consideration. The medium attention will be paid to the stakeholders those have two attributes and highest attention will be given to the stakeholders having all of three attributes power, legitimacy and urgency. These attributes interact in manners which defines stakeholder salience, the degree to which managers give priority to competing stakeholder claims.⁸³ The several combinations of the three attributes lead to the seven classes of stakeholders.⁸⁴

The scholars set up three groups of stakeholders, latent stakeholders be a first group who hold one of the attributes. They can be considered as potential stakeholders rather than actual

⁸¹ Padron, *Turning Corporate Social Responsibility into Opportunity*, 28.

⁸² Crane, *The Oxford Handbook of Corporate Social Responsibility*, 63.

⁸³ Gregory S. Parnell Et al, *Decision Making in Systems engineering and Management* (New Jersey: Wiley & Sons Inc., 2011), 5.

⁸⁴ M. A. Quaddus, and M. A. B. Siddique, *Handbook of Corporate Sustainability: Frameworks, Strategies and Tools* (Cheltenham: Edward Elgar Publishing Limited, 2011), 11.

stakeholders and require only little receptiveness from firm. According to the attributes they possess, this group can be divided into three types further, Dormant, discretionary and demanding stakeholders. Dormant stakeholders are most unimportant ones because they possess the attribute of power and they cannot exercise it on corporation due to the lack of legitimacy and urgency, however corporation should aware from this class, since they may acquire the element of legitimacy and in that way drastically change their standing. On the other hand discretionary stakeholders have legitimate claim on corporation but they lack the element of power and urgency mean urgent need to enforce it. The third class of latent stakeholders is demanding stakeholders possessing the urgent claims against corporation without power and legitimacy.⁸⁵

The second group is Expectant stakeholders which possess two of three attributes, this group can be sub divided into three kinds according to the combination of attributes they possess. Dominant stakeholders are first one possessing power with legitimacy, this kind of stakeholders will have influence on corporation due to these two attributes and managers are bound to pay attention to them. The second type is dependent stakeholders holding legitimacy and urgent claim but who lack power. The third one is dangerous stakeholders which lack legitimacy but possess urgency and power; they may become coercive or even dangerous. Finally a definitive stakeholder is group which possesses all of three attributes defined by Mitchell, Agle& Wood. Dominant stakeholders who are major stakeholders can acquire definitive status when major

⁸⁵ Hillebrand, *Stakeholder Management in Small and Medium-Sized Enterprises*, 29.

decline in share value lead them to challenge company's management by extraordinary general meeting.⁸⁶

⁸⁶ Gerard P. Hodgkinson, and John Kevin Ford, *International Review of Industrial and Industrial Psychology*. Vol. 25 (New York: John Wiley & Sons Ltd 2010), 111.

CHAPTER 3:

SHAREHOLDER VERSUS STAKEHOLDER PERSPECTIVE OF CORPORATE GOVERNANCE MODELS:

3.1. INTRODUCTION:

The contemporary debate about corporate governance between Anglo Saxon and European continental, not only represents two extreme positions but also two different approaches. The core of the dispute is two contradictory and opposing ideologies, cultures and verdict within capitalism. On the one side there is usual perception of individualism, private property rights and the rights of shareholders is the sole purpose of the corporation. Whereas, on the other hand the core concept is ‘the communitarian⁸⁷ notion of property’ which is to institutionalize the corporation socially, in other words based on the idea of “justice for all”, thus more precisely the main focus is to legitimize and accommodate all stakeholders’ interests by corporation.⁸⁸

The question about corporations, whether they are surviving to protect the interest of shareholders, or give priority, to all stakeholders, such as employees, customers and suppliers, give the cause to ongoing debate regarding corporate governance. Corporate governance structure in common Law system including in USA traditionally has been based on the shareholder theory or shareholder modal which promotes that shareholder priority is the pivotal idea around which the whole corporation is designed. The principle to maximize the wealth of shareholders has been primary objective of the working of all corporations relates to the Anglo

⁸⁷ “Communitarianism is a philosophy that emphasizes the connection between the individual and the community. While the 'community' may be a family unit, it is usually understood in the wider sense of interactions between a community of people in a geographical location, or who have a shared history or interest”

⁸⁸ Letza, “Shareholding Versus Stake Holding: A Critical Review of Corporate Governance,” 252.

Saxon approach being the creditors and the employees. Its contemporary model is not the same as it used to be before as early as it was in 1990s, many reforms have been introduced in corporate regulation, as result of the financial scandals and collapses of foremost Corporate Houses like Maxwell, BCCI, and Polly Peck.

The shareholder approach that has traditionally prevailing in U.S. and Germany are not identical, the former emphasizes on the interest of the stockholder, whereas the latter is mainly 'the broader stakeholder approach' emphasizing on the interests of others, especially employees in corporate governance.⁸⁹ Therefore keeping in view of the diversity of the two concepts, the main focus of the chapter is to analyze the two approaches in such a way to evaluate that which one can ensure good corporate governance.

3.2. WHY CORPORATE GOVERNANCE?

The basic requirement of any corporation is to be governed and managed as well; the mechanism which is called corporate governance is concerned with this basic need.⁹⁰ The processes and structures for the direction and control of companies are called corporate governance. "Corporate governance is the system by which companies are directed and controlled." In other words, more precisely it is the tracheotomy of relationships between the management, Board of Directors and stakeholders, including controlling shareholders, minority shareholders and other stakeholders.

Good corporate governance mainly focuses on enhancement of performance, and continues access to external capital, which in turn contributes to sustainable economic development. Besides many, the main factors that label a company well-governed is its accountability and

⁸⁹Frank Clarke, Graeme Dean and Kyle Oliver, *Corporate Collapse: Accounting, Regulatory and Ethical Failure*. 2nd ed. (Cambridge: Cambridge University Press, 2003), 21.

⁹⁰A. C. Fernando, *Corporate Governance: Principles, Policies and Practices* (London: Dorling Kindersley 2009), 51.

transparency to its all components i.e. shareholders and other stakeholders (such as, employees, creditors, customers and the society in general). As result, a company with good corporate governance also contributes to over-all development of a society, such as the environment and social development.⁹¹

The potential conflicts of interest among corporate participants gave rise to the need for good corporate governance. The conflicts of interest in result of agency problems, as Berle and Means (1932) indicated through separation of ownership from control, arises due to corporate actors which have different objectives and imperfect information. The corporate governance mechanism has direct concern with company law that provides discretion to the company management while corporate governance shapes a framework for the exercise of this discretion by distributing powers between directors and shareholders.

In the end of 20th century the ownership structure of large corporation significantly changed and institutions became the major shareholders. The collapse of big corporate houses such as Polly Peck, BCCI, Coloroll, Maxwell Communication Corporation has adverse impact on the British System of Corporate Governance therefore; these corporate scandals and financial reporting irregularities compelled the business communities, market and regulator to realize the importance of good corporate governance.⁹²

3.3. TWO ALTERNATIVE CONCEPTS OF THE CORPORATION AND OF ITS GOVERNANCE:

⁹¹Corporate Governance
[http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/WhyCG_PrintFriendly/\\$FILE/WhyCG.pdf](http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/WhyCG_PrintFriendly/$FILE/WhyCG.pdf) (accessed April 2, 2012).

⁹² Rohit Arora, Structure and Reform of Corporate Governance in the United Kingdom in relation to the Shareholder versus the Stakeholder theory (Glasgow: University of Glasgow, 2010).

The philosophy of corporate governance is based on different theories including shareholder value maximization theory and stakeholder theory. There is no doubt that Corporate Governance focuses towards regulation of directors' duties for the maximum welfare of the shareholders. This notion of corporate governance is basically based on abstract of doctrine of shareholder value, wherein the priority is the interest of shareholders, creating value on their behalf. Thus the objective of corporate organization should be to capitalize the market value of the company to maximum, which will in turn harmonize the interest of minority shareholders, which should be adequately protected.⁹³

However, the argument of imposing wider accountability to corporations has gained importance in the last decade. It has been argued that since corporations possess a separate legal personality absolutely distinct from the management and the owners, corporations owe certain obligations towards wider constituencies which grant certain moral obligations to the corporation to take account of other 'stakeholders'. The term stakeholders, in terms of company law, encompass creditors, employees, suppliers, customers and the society at large. It is often said that the "*corporation is a nexus of contracts*" between various constituencies of the firm who may have an interest in it and it is the contract which determines the rights and obligations of the various stakeholders.

Thus, it may also be said that corporate governance is concerned also with the "social contract that the company may possess with the wider constituencies which morally obliges the former to take account of the interests of other stakeholders."⁹⁴ The different conceptions have their counterpart in different aspects of corporate law, "from the composition and election rules of

⁹³Alberto Chilosi and Mirella Damiani, "Stakeholders vs. Shareholders In Corporate Governance," <http://mpra.ub.uni-muenchen.de/2334/> (accessed April 1, 2012).

⁹⁴ Arora, *Structure and Reform of Corporate Governance in the United Kingdom*, 8.

directors, to the publicity of societal documents, up to the determination of the rules that determine the framework of corporate life, concerning fusions and mergers, takeovers, and the legal framework of capital markets.”⁹⁵ These two conceptions shareholder theory and stakeholder theory the first appears to be dominant, especially in the Anglo-Saxon environment.⁹⁶ In the United States and other Anglo-Saxon economies, the law makes it clear “that shareholders are the owners of firms and those managers have a fiduciary responsibility to act in the interests of shareholders.”⁹⁷

3.4. DIVERSITY IN CORPORATE GOVERNANCE:

The literature on corporate governance distinguishes two different models: the shareholder value model which consider that the only purpose of corporation is to maximize the wealth of shareholders and the stakeholder model which believe that the interest of multiple stakeholders including employees, suppliers, customers need to be considered during decision making of management. In recent literature, the shareholder value model has been “strongly condemned by leading scholars for its tendency to under invest and focus on short-term results and for the fact that it does not take ethical and social values into account.”⁹⁸

The scholars believe that the world has dichotomized itself into “two patterns of share ownership: dispersed ownership of shares and concentrated ownership of shares.”⁹⁹ This different type of ownership structures are behind the emergence of different corporate

⁹⁵ http://mpra.ub.uni-muenchen.de/2334/01/MPRA_paper_2334.pdf (accessed: December 15, 2013).

⁹⁶ Chilosi, “Stakeholders vs. shareholders in corporate governance,” 2.

⁹⁷ “Whose Company Is It? New Insights into the Debate over Shareholders vs. Stakeholders,” <http://www.knowledgeatwharton.com.cn/index.cfm?fa=viewArticle&articleID=1734&languageid=1> (accessed April 1, 2012).

⁹⁸ Christian Stadler, Et al, “The CEO’s attitude towards the Shareholder Value and the Stakeholder Model. A comparison between the Continental European and the Anglo-Saxon Perspectives” http://www.hinterhuber.com/uploads/articles/strategy/CEO_shareholder_stakeholder_value_HH.pdf (accessed April 2, 2012).

⁹⁹ <http://www.opticon1826.com/article/view/4> (accessed: May 27, 2015).

governance models. The US and UK corporate culture is based on dispersed ownership therefore, they are following shareholder model of corporate governance. On the other hand most of European and Asian countries have concentrated ownership structure therefore; they adopt the pattern which is more in alignment with a stakeholder model of corporate governance. Furthermore, there is noticeable difference in degree of protection granted to the shareholders by different countries.¹⁰⁰

3.5. FACTORS THAT SHAPE CORPORATE GOVERNANCE:

The system of corporate governance does not emerge in a space. The corporate governance system of any country always exposes the economic, historical, cultural and legal features of that country. It also gets influenced by the ownership patterns of that country and available financing opportunities. There are certain key players like, financial markets, banking sectors and in some countries there are governments as shareholders who create the significant differences in the corporate governance models.

3.5.1. IMPACT OF OWNERSHIP AND CONTROL STRUCTURES AND PATTERN ON CORPORATE GOVERNANCE:

Corporate governance of any country always has been coupled with ownership and control structure of that economy. Difference between ownership and control structures can be analyzed through the agency factor and this factor is central in corporate governance variances.¹⁰¹

¹⁰⁰Cagman Palmer, "Has the worldwide convergence on the Anglo American style shareholder modal of corporate law yet been assured?" Opticon1826 (2011): 1-12.

¹⁰¹Miguel A. Mendez, "Corporate governance a US/EU comparison," Available at <<http://www.foster.washington.edu/centers/gbc/Documents/Faculty/Miguel%20Mendez%20Final.pdf>> (last accessed: December 10, 2012)

a) OWNERSHIP AND CONTROL PATTERNS THAT PREVAIL IN ANGLO-AMERICAN JURISDICTIONS:

There has been dispersed ownership and control structure in Anglo-American jurisdictions, this dispersion has come about with the rise of the institutional investor. In the jurisdiction of Anglo-American countries, particularly in UK and USA there has been striking change of share ownership from individual shareholders to institutional shareholders during the period of post war.

In 1990, institutional investors “held approximately 61 percent of the shares of UK corporations, and individuals held approximately 21 percent.”¹⁰² In that era institutions held 53.3 percent of the shares of US corporations. “The increase in ownership by institutions has resulted in their increasing influence. In turn, this has triggered regulatory changes designed to facilitate their interests and interaction in the corporate governance process.”¹⁰³

b) OWNERSHIP AND CONTROL PATTERNS THAT PREVAIL IN EUROPEAN CONTINENTAL JURISDICTIONS:

There has been certain degree of ownership concentration, and more importantly a great degree of control concentration in the hand of one or more shareholders “block holders”. “It is bank oriented, instead of financial markets oriented, because of the central role played by financial institutions in providing capital to the corporate sector. It is insider dominated instead of outsider

¹⁰² <http://www.scribd.com/doc/31926447/Three-Models-of-Corporate-Governance-January-2009> (accessed: January 12, 2014).

¹⁰³ “Three Models of Corporate Governance from Developed Capital Markets,” <http://www.emergingmarketsesg.net/esg/wp-content/uploads/2011/01/Three-Models-of-Corporate-Governance-January-2009.pdf> (accessed December 10, 2012).

dominated because these institutions are closely involved in the affairs of the companies, and generally having representation on the board.”¹⁰⁴

3.5.2. INFLUENCE OF THE ECONOMIC MODEL ON CORPORATE GOVERNANCE:

The operational economic model is another feature that shapes, influences and manipulates the corporate governance. The bond and relationship between the prevailing economic actors have great importance in formation of corporate governance. “The economic models of the US and Germany are generally put forward as examples of these two very distinct models.”¹⁰⁵ The market oriented US model has more stress on uncontrolled and unrestrained competition as the government just enacts the regulatory framework and allows the forces and actors to struggle it out. The financial structure of any country has great impact on corporate governance regarding its framework as countries having strong institutional structure are usually based on stakeholder model governance. For instance, the stakeholder model places “greater emphasis on cooperation and consensus between the different economic and market actors.”¹⁰⁶ The market oriented structure, strong financial institutions and many other variations that be present in various

¹⁰⁴ Miguel A. Mendez, “Corporate governance a US/EU comparison,” <http://www.foster.washington.edu/centers/gbc/Documents/Faculty/Miguel%20Mendez%20Final.pdf> (accessed December 10, 2012).

¹⁰⁵ Ibid.

¹⁰⁶ Ibid.

countries do sequentially “have implications and ramifications on that very corporate governance model.”¹⁰⁷

3.5.3. INFLUENCE OF THE LEGAL SYSTEMS ON CORPORATE GOVERNANCE:

The two contrary views, neo classical and path dependent explained the reasons for preference of a certain structure which should be acquired for the corporate governance. Therefore, the economists that are proponents of neoclassical view “insist that firms choose their corporate structures based on simple efficiency considerations: the most efficient ones are chosen accordingly.”¹⁰⁸ Whereas, the contrary view Path dependence assumes that the corporate governance structures in different countries are intensively influenced and embedded by the historical traditions and initial ownership structures of organizations. A great defender of this opinion Roe advanced this view by explaining political theory that motivating the differences in ownership structures. Likewise, he further explained that the corporate governance structure is formed not only by legal limitations but there is also control of financial organizations and these limitations have political justification. “A relatively recent example with former Soviet Union countries effectively shows, how the new political power determines new economic environment, and particularly ownership structures after the collapse of soviet regime”.¹⁰⁹

There are several authors argue that regulation about corporate governance was influenced by external political or legal factors. The robust supporters of this category of literature are Roe on

¹⁰⁷Ibid.

¹⁰⁸ http://www.luys.am/images/scholars/attachments/Mariam_Simonyan-Corporate-governance.pdf (accessed: January 13, 2014).

¹⁰⁹“Sir Geoffrey Owen and Louis Turner, http://www.luys.am/images/scholars/attachments/Mariam_Simonyan-Corporate-governance.pdf> (accessed December 2, 2012).

one side and La Porta, Lopez-de-Silanes, Shleifer, and Vishny on the other. Therefore, they start with opposing assumptions regarding to what could be the efficient structure and further explained “the factors that have deterred some countries from pursuing the efficient path. Roe argues that, the development towards dispersed ownership in the US was fostered by political movements”¹¹⁰ that caused the low ownership concentration in US put regulatory restrictions on strong financial institutions. “The attention to legal systems in corporate governance studies begins with the study conducted by la Porta et al, which investigates how the existence of laws protecting investors and the quality of enforcement of the laws determine corporate ownership patterns in a country.”¹¹¹ Therefore, La Porta, Lopez-de-Silanes, Shleifer, and Vishny have different opinion that the progress towards dispersed ownership depends on the strength of shareholder protection provided by the law. However, it is influenced by the legal structure or system that the jurisdiction belongs to. The European continental approached or Civil law countries appear to have been failed to provide effective, protective law without dispersed ownership structure due to their legal tradition and framework.¹¹² On other side, in common law based countries they have maximum protective laws for shareholders with concentrated ownership structure. Roe and Bebchuk are of the opinion that the groups have power in companies may influenced lawmakers to legislate incompetent or inefficient law that favour them to gain individual benefits in structure based on stakeholder model that they extract from the firms through the exercising of their control. These influential groups or units would be the

¹¹⁰ http://www.law.harvard.edu/programs/olin_center/papers/pdf/303.pdf (accessed: January 22, 2015).

¹¹¹ Nor Zalina Mohamad Yusof, “Bumiputera Institution and the Development of Corporate Governance in Malaysia,” (United Kingdom: Manchester Business School publication), <https://www.escholar.manchester.ac.uk/api/dastream?publicationPid=uk-ac-man-scw:189459&datastreamId=FULL-TEXT.PDF> (accessed October 23, 2013).

¹¹² Markus Berndt, “Global Differences in Corporate Governance Systems Theory and Implications for reforms” (United Kingdom: Harvard Law School Cambridge publication) http://www.law.harvard.edu/programs/olin_center/papers/pdf/303.pdf (accessed October 20, 2013).

managers/management in the stakeholder system/outsider system and ruling shareholders in the shareholder system/insider system likewise.¹¹³

3.6. KEY CHARACTERISTICS OF SHAREHOLDER PERSPECTIVE OF CORPORATE GOVERNANCE:

This approach of governance is referred as shareholder oriented based on shareholder theory. "It is called Anglo Saxon approach to corporate governance being the basis of corporate governance in USA, UK, Canada, Australia and other common wealth law countries including India and Pakistan."¹¹⁴ Corporate governance system based on the theory of shareholder primacy has been prevailed in Anglo-Saxon jurisdictions. How this theory is applicable in practice it can be observed through the structure of corporate governance in any economy providing absolute protection to investors. This type of governance system can be characterized by ownership of individual increasingly moving towards institutional and defined legal framework protecting the rights of main key players, shareholders, directors and management and providing uncomplicated procedure for interaction between them.

The method of equity financing has been adopted by the Anglo-American to raise the capital; particularly UK and USA have robust market system. "It is not surprising, therefore, that the US is the largest capital market in the world, and that the London Stock Exchange is the third largest stock exchange in the world in terms of market capitalization after the New York Stock Exchange (NYSE) and Tokyo."¹¹⁵

There are two features in any governance model that "shape the interactions and relationships between the various parties in the governance process. First one is Board structure: the

¹¹³ Ibid.

¹¹⁴ Fernando, *Corporate Governance: Principles, Policies and Practices*, 48.

¹¹⁵ Three Models of Corporate Governance from Developed Capital Markets.

organizational framework the governing body operates under. Secondly is Board composition: who is represented on the governing body.”¹¹⁶ There are two types of board structures of companies prevailing worldwide. Common law system as well US jurisdictions based on shareholder perspective of governance observe the one tire or unitary system: the governing body comprising one board. “The two-tier board institutionalizes a clear distinction and segregation between the supervisory and monitoring functions on the one hand, and the managerial functions on the other hand.”¹¹⁷ In Anglo-American model, it is rare that “the CEO is not on the board, and he/she effectively holds tremendous power.”¹¹⁸

The basic issue of this type of governance is agency problem because, whether or not shareholder’s interest is effectively protected in current institutional corporate arrangements. Since shareholders have to delegate their powers to directors and managers on behalf of all shareholders so there is possible risk that management may serve for their own interests on cost of all shareholders. This problem increase since the 20th century as the doctrine of ownership and control enhance the powers of management to promote their self-interest. The reason of this issue explored by scholars is self-interest human behavior, according to them agency problem can occur in any case where principle agent relationship exist. The second issue is that principle and agents may act differently due to their different attitude towards risk.¹¹⁹ The examples of Enron and WorldCom reveal that managers can improve their interests at the cost of shareholders in dispersed ownership structure. Likewise, the scandal about Adelphia and Parmalat reflects that

¹¹⁶ <http://www.forumpartnerships.zsi.at/attach/MiguelMendezFinal.pdf> (accessed: December 15, 2015).

¹¹⁷ Mendez, “Corporate governance a US/EU comparison,” 45.

¹¹⁸ Owen, “Corporate Governance,” 53.

¹¹⁹ Letza, “Shareholding versus Stake Holding: A Critical Review of Corporate Governance,” 248.

how block holders or controlling shareholders can improve and enhance their interests at the cost of the minority shareholders in concentrated ownership structure.¹²⁰

3.7. KEY CHARACTERISTICS OF STAKEHOLDER MODEL OF CORPORATE GOVERNANCE:

The stakeholder model of governance closely relate to “socially courteous” market economy. This type of model is usually based on two tire board structure “For example, German corporations are comprised of a dual board system: a supervisory board that is responsible for strategic decision-making, and a managerial board that is responsible for the execution of the day-to-day strategies (a broadly similar system is present in the Japanese corporate system)”.¹²¹ These two are completely dissimilar therefore; no person can work at the same time on managerial board and supervisory board. It is pertinent to mention here that the size of supervisory board is determined by law and cannot be amended by shareholders. Moreover, the Germany and other countries following this model, “voting right restrictions are legal; these limit a shareholder to voting a certain percentage of the corporation’s total share capital, regardless of share ownership position.”¹²²

The stakeholder corporate governance model varies significantly from Anglo-US or shareholder model, though some of its elements/basics resemble the Japanese model. The stakeholder model also varies on the point that the banks/financial institutions hold enduring stakes/shares in corporations. Therefore, the banks representative play vital role to elect board of directors. The corporations based on stakeholder model of governance ordinarily choose the bank financing rather than equity financing. For example, the “stock market capitalization of Germany is small

¹²⁰ Owen, “Corporate Governance” 4.

¹²¹ http://www.unescap.org/pdd/publications/adpj_11_2/2_cheung_chan.pdf (accessed December 1, 2012).

¹²² Three Models of Corporate Governance from Developed Capital Markets,” 10.

in relation to the size of its economy.”¹²³ Furthermore, the level of individual stock ownership in Germany is low, due to its conservative investment strategy. “It is not surprising therefore, that the corporate governance structure is geared towards preserving relationships between the key players, notably banks and corporations.”¹²⁴

It has also been observed that the corporations operating under stakeholder model of governance are also shareholders at the same time having long term shares in other large corporations. “It is to some extent resemble, but not corresponding to the Japanese model. However, above mentioned model is very different from the Anglo-US model where neither banks nor corporations are key institutional investors.”¹²⁵

¹²³ http://www.unescap.org/pdd/publications/adpj_11_2/2_cheung_chan.pdf (accessed December 1, 2012).

¹²⁴ Ibid.

¹²⁵ Ibid.

CHAPTER 4:

CONVERGENCE OF BOTH THEORIES IN PERSPECTIVE OF CORPORATE GOVERNANCE

INTRODUCTION:

Corporate governance patterns continue to differ markedly across countries in spite of decades of economic globalization and twenty years of intense financial globalization.¹²⁶ The corporate governance structures and related laws are different across countries following different corporate theories. They vary regarding importance of large shareholders, legal protection of shareholders and the extent to which relevant laws are enforced, the treatment of stakeholders like creditors, employees, management and labor. There is also a major difference regarding the structure of the board of directors. The ownership structure also matters as discussed in preceding chapter, "concentrated not dispersed ownership is still rule rather than the exception throughout the world"¹²⁷ and so is family owned or controlled even large corporations or groups in most of the countries. Now the question is what is the impact of globalization on this rapidly changing corporate world? Whether the globalization is reducing the diversity in corporate governance practices across the countries or not? Whether there is convergence of two opposite theories of corporate governance through recent legal reforms particularly after Enron collapse? Whether there is a development of Hybrid model having characteristic of both

¹²⁶ <http://jonescenter.wharton.upenn.edu/papers/1999/wp99-11.pdf> (accessed: December 15, 2014).

¹²⁷ <http://jonescenter.wharton.upenn.edu/papers/1999/wp99-11.pdf> (accessed: December 15, 2014).

theories?¹²⁸ In this chapter we'll bring down the all these questions under discussion, we will try to provide a theoretical framework for analyzing and explaining convergence in corporate governance and, as it is, for analyzing and explaining convergence of legal structures in general.

4.2. **WHAT IS GLOBALIZATION?**

The transformation and conversion of the world have caused the globalization as most deliberated and contemporary topics in the corporate management. The many scholars and experts are of the opinion that the globalization has become a great progression, an inevitable movement, an article of faith. There are many others, those consider it as a devastating force, anarchy and the modern occurrence overflowing the world. Globalization is disseverment of time and space in other words shrinking of the world. Globalization of the world has immense impact on all sections of the life including corporate sector of all countries. As we talk about globalization, it would be expected to associate with escalating trade, and exchange of services, money, people, information, and culture between states. It also causes the economies more inter-reliant regarding trade, commerce, investment, and macroeconomic policy. It is also pertinent to mention here that the economic, political or cultural globalization do not have same extent of influence on all countries or economies. "The experts of comparative organizations sociologist have been conducted the comparative research and presented the qualitative and quantitative evidence to the effect that firms pursue different modes of economic action and adopt different organizational forms depending on the institutional and social structures of their home countries even as globalization increases".¹²⁹

¹²⁸ Thomas Clarke, *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (London: Routledge, 2004), 86.

¹²⁹ Mauro F. Guillén, "Corporate Governance and Globalization: Arguments and Evidence and Evidence against Convergence" Published by The Wharton School and Department of Sociology

4.3. GLOBALIZATION OF CORPORATE GOVERNANCE CAUSING THE CONVERGENCE OF BOTH THEORIES:

The corporate governance models across the world differ due to the based on two opposite theories. As we discussed above, the countries consider their legal, economic, political structures while they implement and adopt corporate model and related theory on which philosophy, it would be based. There is current discussion about globalization that it causing the convergence of different economic systems those have also different corporate structure and corporate governance models.¹³⁰ In the present scenario financial globalization of the world have great impact on the briskly varying corporate world. Therefore, the exceeding growth of international trade because of the growth of foreign direct investment has also given rise to the importance of corporations 'internationalization strategies' regarding developing pattern of the industrial and investment processes.¹³¹ It is also pertinent to mention here that the developing pattern of the industrial and investment process of corporations caused the globalization more apparent than previous, as the OECD acknowledged:

.....[globalization of industry refers to an evolving pattern of cross-border activities of firms involving international investment, trade and collaboration for purposes of product development, production and sourcing, and marketing. These international activities enable firms to enter new markets, exploit their technological and organizational advantages, and reduce business costs and risks. Underlying the international expansion of firms, and in part driven by it, are technological advances, the liberalization of markets and increased mobility

University of Pennsylvania: Available at <http://knowledge.wharton.upenn.edu/papers/839.pdf> (accessed November 26 2013).

¹³⁰ Mathias M Siems, *Convergence in Shareholder Law* (Cambridge: Cambridge University Press, 2008), 334.

¹³¹ Marie Dela Rama & Thomas Clarke, "Introduction: The Governance of Globalization" Available at; <http://www.ccg.uts.edu.au/pdfs/governance-and-globalization-intro.pdf> (accessed November 26, 2013).

of production factors. These complex patterns of cross border activities increasingly characterize the international economic system and distinguish it from the earlier predominance of arms-length trade in finished goods.¹³²

The early 90s witnessed the globalization of financial investment and money managing. Therefore, it had been urged a further point of view or prediction about convergence on the Anglo Saxon model, owing to the reason that it is based on market principle. Consequently, the majority economist and financial experts all of the world have preference to corporations, who give priority to the shareholder rights and maximize the shareholder wealth and they are efficient as to the transparency in their reporting of corporate activities and result.¹³³

The concept of convergence has been evolved through systemic process since its beginning. However, convergence belongs to the process during that, the evolution and changes of Law take place, which is basically one of the important issues of legal theory. The evolution of Law always takes place to the betterment of the one's interest that brings it into existence. Therefore, various corporate law scholars/ intellectuals are of the opinion that the convergence in corporate governance is a convergence towards a model of shareholder value maximization based on shareholder theory or towards more stakeholders protection based on stakeholder theory, or more generally to the most well organized structure of corporate organization, otherwise some worldwide approved/ settled best practice standard close to hybrid/ shareholder enlightened model of corporate governance.¹³⁴

¹³² Ibid.

¹³³ Clarke, *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, 179.

¹³⁴ Hans-Ueli Vogt, "Convergence in Corporate Governance in Light of Globalization" Presentation Given at the International Conference on Law and Society in the 21st Century (Berlin, July 25-28, 2007), <http://www.rwi.uzh.ch/lehreorschung/alphabetisch/vogt/publikationen/ConvergenceBerlin.pdf> (accessed November 26, 2013).

4.4. CAUSES BEHIND THE CONVERGENCE OF BOTH THEORIES:

There are many other factors/causes than globalization; those are concerned in the development or evolution of the convergence in theories and corporate governance models based on these theories.

It could be observed in diverse forms, like foreign direct investment by firms under the pressure of various corporate governance systems in their home countries. Therefore, the influence of institutional investors including the proportion of listed corporate equity held by different types of shareholders would also be considered as major factors that are involved in the convergence of above mentioned theories.¹³⁵

The more conservative or traditional approach towards convergence is that the expansion or enlargement of distant multinationals would compel the convergence of corporate governance models. Therefore, we suppose that perhaps it is factual that multinational corporations are a constant force; however, the question arise about its approach, whether these multinationals are moving toward more shareholder protection or shareholder enlightened theory (shareholder protection along with stakeholders). Whereas, on other side if we presume that the Multinational corporations are in favor of shareholder theory then it is difficult to analyze that why it should be supposed to make a worldwide convergence of corporate governance on the shareholder model. “The reason for this doubt is that the impact of foreign investment originating from countries with an Anglo-Saxon legal tradition and market-based corporate governance system is

¹³⁵ Guillén, “Corporate governance and convergence: Argument and evidence against convergence” 67.

weakening. Another factor is that the economies are depending on each other for their survival and to meet with international corporate standers.”¹³⁶

4.4.1. CRISES OF CORPORATE GOVERNANCE:

The corporate governance systems based on diverging theories i.e. (shareholder theory and stakeholder theory) has encountered the chronic era of crisis that have depicted the structural and organizational weaknesses of their systems. While we discuss the prevailing corporate governance model in all over the world, therefore; we could observed that the acclaimed financial institutions and organizations like OECD, World Bank and IMF were progressively and assertively projecting the shareholder primacy in other words Anglo-Saxon market based outsider system of governance as the most excellent and paramount model and all other economies might should learn from it.¹³⁷

The time came when the world renowned economy went through the terrible economic disaster (Enron collapse) in the corporate history. The US corporate governance system strictly pursuing the shareholder theory at that time capitulated to the other evil lingering wave of corporate frauds and bankruptcies of 2001 to 2002 directing to the collapse of the NASDAQ and NYSE. The collapse of big corporate shots emerged the hot debate regarding the inevitability of corporate governance which ultimately marked the new question as regards to the best suited theory on which corporate governance system should be based on. In 90s, the economy of the US was appeared as vibrant, viable and performance oriented economy of the world. Therefore, eventually it had confronted the abhorrent behaviors between executives, auditors and

¹³⁶ Ibid.

¹³⁷ Rama, *Introduction: The Governance of Globalization*, 9.

accountings which ultimately lead to the deceptions and criminal conspiracy between all of them. The US economy had experienced the above mentioned stumbling blocks while pursuing the philosophy of shareholder primacy and corporate governance structure based on the same.

Whereas, when we examine the economies based on Stakeholder theory oriented corporate governance systems therefore; we explore that they had also experienced a number of incisive complexity in their respective corporate governance system. However, the stakeholder oriented corporate governance of Europeans have not experienced or observed anything as disastrous as the corporate breakdowns in the US, although the US economy was considered as paramount model of corporate governance by the financial institutions.¹³⁸ Moreover, diverse corporate governance systems all over the world have been demonstrated an incapability to be active and to act in a non-disastrous situation and without any conflict of interest between management, shareholders and stakeholders. Many jurists are of the opinion that the internal mechanisms of various corporate governance models based on diverse theories are not ample to control the crisis solely.¹³⁹

4.4.2. LEGAL CONVERGENCE:

The legal convergence denotes to the reforms in legal rules and enforcement mechanism towards some successful standers. The legal structures relating to the corporate governance based on different assumptions either it is based on shareholder theory (more protective towards shareholder) or stakeholder (equal protective towards shareholders and stakeholders). The modern research has been conducted in the region of corporate governance that has recognized the numeral experimental regularities. Therefore, the financial systems of various countries having

¹³⁸ Ibid.

¹³⁹ Terrence C. Sebora and Michael J. Rubach, "Comparative Corporate Governance: Competitive Implications of an emerging convergence," *Journal of World Business* 33 (1998): 167-184.

diversified constituents, e.g. (the wideness and extent of their capital markets, corporate ownership structure, and surplus strategies) have become cause to expose the legal protection given by them to their foreign investors. According to that research, one could understand the patterns of corporate finance and corporate governance of any country by the degree of legal protection of shareholders and creditors surviving under the legal system of that very country. Thus, the corporate governance is a method or system by which the foreign investors could protect them against the confiscation by the insiders.¹⁴⁰

A noble foundation professor of Economics La Porta gives a set of basis laws protecting shareholders and stakeholders and records the pervasiveness of these basic laws in 49 countries around the world. They combined these legal rules into shareholder and creditor rights index for each country in perspective of shareholder and stakeholder theories and consider several procedures of enforcement quality e.g. the effectiveness of the judicial system and quantify the quality of accounting standards. La Porta analyze the investor protection to examine the variation of legal rules and enforcement quality across countries and across legal systems based on different philosophies regarding shareholder and stakeholder. Therefore, the two legal systems prevailing in the world e.g. common law and civil are very clear regarding their corporate governance models; as we discussed in preceding chapter, they both have different ownership structure pattern and theories in relation to corporate governance. Similarly, they have also diverse origin of Law e.g. the common law system having Legal set of laws usually organized by Judges based on precedents and principles of natural justice and equity. Therefore, it is merely expect from Judges to apply their mind according to the matter and situation; the like it is

¹⁴⁰ Rafael La Porta et al, "Investor Protection and Corporate Governance" Journal of Financial Economics 58 (2000): 3-27.

expected in the case of corporate governance and investor protection. The common law system expands the legal precedents to the further violation of fiduciary duty and gives the maximum protection to the investor that is the basis of shareholder theory. On the other side, the civil law systems are based on the statutes and judges are not expected to apply their own mind on the basis of natural justice and equity. Therefore, the common law system is more protective for the shareholders or investors.¹⁴¹ Currently, the hot debate is going on regarding the convergence and reforms of two different legal systems. However, it is important to start with its objectives, why corporate governance needs so? The analysis of pro stakeholder theory suggests that one objective of corporate governance reform is to protect the shareholders including stakeholders to achieve the maximum growth in economy. The other view is the legal protection should be given to the shareholders to more strengthen them; instead of both shareholder and stakeholder. We will analyze the scope of legal convergence of both theories through legal reforms in their governance models.

4.4. RECENT DEVELOPMENT IN UK:

There is divergence on a lot of aspects regarding the corporate governance structures based on different theories; it is fact that one structure is not fit to all as the most of the countries do have family owned companies instead of large listed corporations. Therefore, due to the many reasons the world wide convergence has been taking place regarding core aspects of the corporate governance i.e. transparency, disclosure and the role of independent non-executive directors including the extent to which the stakeholders should be protected for the better interest protection of shareholders.¹⁴²

¹⁴¹ Ibid.

¹⁴² Christine Mallin, *Corporate Governance*. 4th ed. (Oxford: Oxford University Press, 2010), 23.

When we talk about the legal or extra statutory reforms in the corporate structure of UK, therefore; we observed that the Cadbury committee Report in 1992 could be considered as milestone regarding extra statutory legal reforms of corporate governance which caused the large listed companies of UK to move into the direction of two tier model of corporate governance. The Cadbury committee was established to exposé the causes behind the major corporate scandals, in consequence it proposed the general reforms in the British corporate governance board of structure including the fair role of auditors. Therefore, the other three successors of above mentioned report have also required improving the role of independent non-executive director and the other monitoring function of the Board of governance. The two tier board of governance is characteristic of corporate of governance applicable in the countries following the stakeholder model of governance while protecting the rights of shareholders including stakeholders. Although the corporate governance structure of UK is based on shareholder primacy and practicing one tier board of governance but the questions is whether functionally or practically it becomes the two tier board of governance after the issuance of above mentioned reports?. Therefore, these extra statutory reforms moving the corporate structure of UK to two tier of board of governance functionally do not have similar impact regarding stakeholders particularly employees; as two tier governance system following stakeholder theory does have. It could be analyzed through the role of supervisory board in two tier board of governance because the supervisory board does have close linkage with stakeholders and other monitory functions regarding stakeholders whereas it lacks in the corporate governance system of UK even after that extra statutory reforms.¹⁴³

The corporate scandals caused the emergence of enlightened shareholder value theory and legal reforms on basis of it i.e. the company's law reforms bill 2006 was approved by the Parliament.

The slogan of enlightened shareholder value theory is not only to protect the shareholder profit

¹⁴³ Paul Davies, "Board Structure in the UK and Germany: Convergence or Continuing Divergence?" University of Oxford- faculty of Law, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=262959 (accessed March 9, 2014).

maximization but it also give emphasize on the long term value creation of the firm by considering and protecting the interest of stakeholders. Therefore, the legal reforms which have been introduced in the companies Act 2006 based on the principle of the enlightened shareholder value. The most significant reformation has been made by the insertion of the section 172 which requires the Directors to promote the success of the company and further it requires the Director to act in faith good, promote the success of the company, give regards to the interests of the company's employees, to build trustworthy relationship with the suppliers, customers.¹⁴⁴ It is pertinent to mention here that under section 172 the Directors owned their duty towards all members of the corporation as whole whether shareholders or stakeholders. Since it is the first time that the law has explicitly required the directors of the company to give regards to the interests of its stakeholders.¹⁴⁵

The Insolvency Act 1986 is another movement towards protection of stakeholder's interest (creditors). Particularly the Provisions of fraudulent and wrongful trading are incorporated in Sections 213 and 214 of the Insolvency Act, 1986, respectively. The provisions seek suggest to increase the pool the assets by the Directors towards assets of the company.¹⁴⁶ In other words, the provision will disregard the separate entity concept of the company and will make its directors personally liable to secure protection to its creditors.¹⁴⁷

4.6. REFORMS IN USA:

The US has developed securities markets and better protection of shareholders under Law; as for

¹⁴⁴ file:///C:/Users/ComINN/Downloads/SSRN-id1625750.pdf

¹⁴⁵ file:///C:/Users/ComINN/Downloads/SSRN-id2139528.pdf

¹⁴⁶ An introduction to English Insolvency Law, Slaughter and May

<http://www.slaughterandmay.com/media/251437/an-introduction-to-english-insolvency-law.pdf> (accessed May 23, 2015).

¹⁴⁷ A.J. Dignam and J.P. Lowry, *Corporate Finance and Management Issues in Company Law* (London: University of London, 2009), 22.

as US corporate structure is concerned we have discussed it in preceding chapter. It has corporate governance structure and corporate legal structure based on the principle of shareholder primacy i.e. the US has strict statutory provisions explicitly for the protection of investors. The US securities regulation has tremendous progress since 30's and currently it has covered the many central corporate governance issues; for instance, shareholder meetings, voting rights, insider trading, takeovers and securities fraud. Therefore, it also deals with board composition and functioning after the enactment of Sarbans Oxley Act. It is also point to be noted that the vile scandals of big corporations resulted the reforms in the corporate laws and in the light of reforms the main stock exchanges have required the independence of directors and it also emphasized the internal control mechanism through audit committees. Further, "independence requirements have been tightened and audit committees' powers and responsibilities have been extended."¹⁴⁸

These corporate scandals also lead the US states towards convergence of two corporate governance approaches, shareholder primacy and stakeholder theory. The states of USA have enacted the constituencies Laws which requires the Directors to consider the interests of non-shareholders (stakeholders) as well. The Pennsylvania legislature passed "the first stakeholder statute in 1983 and forty other states have subsequently implemented similar statutes."¹⁴⁹ Therefore, the enactments of United States constituency Laws regarding corporations are founded on the enlightened shareholder value like UK where this approach is also basis of the contemporary legal reforms. For instance, the Delaware state which has undeviating attraction for business community has not enacted any constituency law and it is very notable exception to

¹⁴⁸ John C. Coates IV, "The Goals and Promise of the Sarbanes-Oxley Act," *The Journal of Economic Perspectives* 21(2007):91-116.

¹⁴⁹ Kathleen Hale, "Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes," *Arizona Law Review* 45 (2003): 823-856.

that constituency laws¹⁵⁰ but still in practice its following the concept that the management in debts “its fiduciary duties of care and loyalty not only toward shareholders but to the corporation as whole including stakeholders.”¹⁵¹ This assumption not only recognizes the status of shareholders as owner and principle but simultaneously acknowledge that the management is not only agent of shareholders but to the whole entity of the corporation including stakeholders i.e. creditors, employees, community and it has to work for the well-being of entire corporation. Moreover, it is pertinent to mention here that these pro stakeholder statutes have been adopted by almost 41 states of the US.¹⁵² Wyoming’s state Statute is an example of a comprehensive stakeholder statute.¹⁵³ These statutes expressly authorize “the board of directors to consider stakeholders (no shareholder) interests, which are usually expressed in terms of a list including employees, customers, suppliers, creditors, and local communities.”¹⁵⁴ However, these statute laws differ regarding its implication form each other, for example the nineteen states allow stakeholder consideration only during takeover or change of control situations. While some stakeholder statutes are mandatory and some are permissive in nature. There are also the examples of stakeholder statutes which explicitly determine the extent to which the stakeholder interest has to be considered.¹⁵⁵ Besides, there are also examples of states which consider the interest of stakeholders as whole. The emergence and implication of these statutes are very important in terms of recognizing the purpose of corporation because they represent deliberate and intentional rejection of the shareholder primacy conception or shareholder model of

¹⁵⁰ file:///C:/Users/ComINN/Downloads/corporatevirtus2007.pdf

¹⁵¹ file:///C:/Users/ComINN/Downloads/SSRN-id1625750.pdf

¹⁵² David K. Millon, "Redefining Corporate Law," *Indiana Law Review* 24 (1991): 223- 277.

¹⁵³ Hale, "Corporate Law and Stakeholders," 833.

¹⁵⁴ http://www.mcgeorge.edu/Documents/Conferences/GlobeJune2012_HumanRightsandDelaware.pdf (accessed: July 12, 2015).

¹⁵⁵ Hale, "Corporate Law and Stakeholders," 833.

corporate governance and managerial responsibility in this regard.¹⁵⁶

On the other side there is example of Delaware State who does not have any constituency laws in this regard and pursuing the central corporate law and governance model but still its Courts' Decisions reflects the convergence towards pro stakeholder theory. For instance, the Supreme Court of Delaware added that the Directors or management may consider the impact of their decisions on constituencies (stakeholders) other than shareholders i.e. creditors, customers, employees, and the community usually with condition that it should not be on expense of shareholder but for the long term benefits of the shareholders i.e. "In Revlon Inc. V. MacAndrews & Forbes case, the Delaware Supreme Court held the same."¹⁵⁷ Although it's contrary to the traditional Law of shareholder primacy therefore, proponents of shareholder theory are worry about the norms of shareholder theory as according to their opinion these statute laws will ultimately upset the relation of fiduciary duty of Directors towards management. While the above mentioned observation regarding pro stakeholder statute laws we can say that the US corporations are ultimately converging towards the enlightened shareholder value. Therefore, we can say that the company Act 2006 provides innovative concept of "Social Corporation" to the corporate world that is influential around the world. In the 'enlightened shareholder value' context, the directors are responsible for promoting the success of the company for the benefit of the members as a whole. However, the British model expects that in addition to 'enlightened shareholder value' approach, the directors should have regard to pluralist factors relating to impact of companies' operation on the community and the

¹⁵⁶ Ibid.

¹⁵⁷ file:///C:/Users/ComINN/Downloads/corporatevirtus2007.pdf

environment¹⁵⁸. The directors' duty to promote the 'success of the company' gives regard to shareholders' interest primarily and rest of the corporate constituency.

4.7. SLIGHT CONVERGENCE IN GERMANY:

The German corporate legal framework ensures that the corporations are stakeholder oriented¹⁵⁹. The Germany comes under the ambit of European continental approach; therefore, the German corporate system is based on stakeholder theory and the corporate governance model which has been pursued in Germany is stakeholder model. In previous chapters we have discussed in detail the salient features of stakeholder theory and stakeholder model of governance. Moreover, the concentrated ownership structure unlike to the UK and US remains particular individuality of German corporate system. The ownership structure is usually observed as concentrated, if a single shareholder owns at least 20 percent therefore, many empirical studies resulted the German ownership structure as concentrated.¹⁶⁰ Furthermore, the division between a management board and a supervisory board is another specific and unique feature of German corporate Law. This two-tier board system noticeably differentiates the German corporate governance system from others. The nature of this separation of Boards is mandatory for listed large corporations and large limited liability companies. The management board consists of executive directors whereas the supervisory board consists of non-executive or outsider "directors members of the management board cannot serve as members of the supervisory board and vice versa."¹⁶¹ Likewise, the German corporations are legally required to pursue the interests

¹⁵⁸ The Company Act 2006, S.417.

¹⁵⁹ Franklin Allen, Elena Carletti and Robert Marquez, "Stakeholder Capitalism, Corporate Governance and Firm Value" <http://finance.wharton.upenn.edu/~allenf/download/Vita/JF-MS6731-Revision-corporate-governance-with-figures-16sep09-final.pdf> (accessed May 23, 105).

¹⁶⁰ Jürgen Odenius, "Germany's Corporate Governance Reforms: Has the System Become Flexible Enough?" <https://www.imf.org/external/pubs/ft/wp/2008/wp08179.pdf> (accessed May 23, 2015).

¹⁶¹ Theodor Baums, "Corporate Governance in Germany" <http://www.jura.uni-frankfurt.de/43029805/paper70.pdf> (accessed May 23, 2015).

of stakeholders (non-shareholders) through the system of co-determination¹⁶² in which “employees and shareholders in large corporations have an equal number of seats on the supervisory board of the company.”¹⁶³ Though, German corporate governance has unique and distinctive model of governance and board structure but occurrence of rapid change in the corporate culture all over the world causing the slight convergence towards shareholder theory. For instance, the German Code of corporate governance was first published in 2002 and last amended in 2008. It has tried to improve the understanding of investor towards Germanys’ corporate governance framework and complex ownership structure. It also emphasized the need of transparency, clarifies the law on shareholders voting rights and promotes the trust of investors.¹⁶⁴ Therefore, current developments in German code of corporate governance regarding transparency and fair disclosure are evidence that the old structural elements from stakeholder-oriented models (e.g. employee co-determination) are being merged with newer elements of shareholder models as to the transparency and disclosure.¹⁶⁵ Despite that development in Germany another visible sign of this convergence is the incisive rises in the remuneration of senior managers.¹⁶⁶ It is also important to mention here that the oratory of shareholder theory is now commonly used in large German corporations as many big corporations have made arrangements regarding investor relations departments on the pattern of Anglo-Saxon. Moreover,

¹⁶² Co-determination is a practice whereby the employees have a role in management of a company. The word is a literal translation from the German word “*Mitbestimmung*”

¹⁶³ Allen, "Stakeholder Capitalism, Corporate Governance and Firm Value" 1.

¹⁶⁴ Odenius, "Germany's Corporate Governance Reforms", 8.

¹⁶⁵ Gregory Jackson and Andreas Moerke, “Continuity and Change in Corporate Governance: comparing Germany and Japan” Corporate Governance: An International Review 13 (2005): 351-362.

¹⁶⁶ Phil Almond, Tony Edwards and Ian Clark, “Multinationals and changing national business systems in Europe: towards the ‘shareholder value’ model?” Industrial Relations Journal 34 (2003): 430- 446.

many large corporations have also adopted international accounting standard to gain the trust of foreign investors.¹⁶⁷

In 2002 new Transparency and disclosure Law was enacted which requires the management to make more information available to shareholders. Therefore, it can be said that it was another attempt towards strengthening the outsider shareholders and it is based on the characteristic of shareholder theory.¹⁶⁸

These quite major changes have strong impact on foreign investment as a remarkable increase can be seen in the proportion of shares held by foreign institutional investors from 4% in 1990 to 13% 1998. Consequently, the German model of corporate governance is moving towards hybrid model (combination of stakeholder model and shareholder model).¹⁶⁹

4.8. CASE STUDY OF INDIA:

The Indian legal system has legacy and roots in common Law system. Therefore, the common law based legal system provides the best protection to investor's rights. Accordingly, in Indian legal system the rights given to the shareholders are evident to the maximum legal protection which has been offered to the investors. For instance, India has shareholder protection equal to that of the USA and UK.¹⁷⁰ Subsequently the Indian corporate governance model also somehow relates to the UK corporate governance model and follows the shareholder primacy theory. However, "the corporate ownership in India is predominantly concentrated in the hands of

¹⁶⁷ Tony Edwards "Corporate governance, industrial relations and trends in company-level restructuring in Europe: convergence towards the Anglo-American model?" *Industrial Relations Journal* 35 (2004): 518-535.

¹⁶⁸ Almond "Multinationals and changing national business systems in Europe" 430-446.

¹⁶⁹ Edwards "Corporate governance, industrial relations and trends in company-level restructuring in Europe," 518-535.

¹⁷⁰ Rajesh Chakrabarti, "Corporate Governance in India – Evolution and Challenges"

<http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN023826.pdf> (accessed May 23, 2015).

domestic individuals and promoter groups, multinational parents, or the state.”¹⁷¹ Therefore, the Indian corporate structure has concentrated ownership such as one-third of Indian companies are controlled by one or more family members. The level of concentration is confirmed by different studies, which found “that 17 of the 30 companies in the Bombay Stock Exchange were family-controlled in 2007.”¹⁷² On the other hand The Indian board of structure is based on single tier board system like UK and US.¹⁷³ In this way we can observe that the Indian ownership structure differ to the US and particularly to the UK but India has similar corporate governance structure as to the US and UK. Furthermore, it could be examined that the Indian corporate philosophy is going behind the shareholder theory or shareholder primacy. For instance, the establishment of Securities and Exchange Board of India (SEBI) in 1992 could be considered “the most important development in the field of corporate governance and investor protection in India.”¹⁷⁴

Despite the fact that Indian corporate environment is influenced by the shareholder theory the requirement to protect the stakeholders as whole is realized by the Indian corporate experts. In this regard the milestone development in the evolution of corporate governance in India was achieved when the report of Kumar Mangalam Birla committee of SEBI was submitted in 1999. This report was very comprehensive and SEBI considered it as definitive statement on corporate governance in India. The said committee recognized the reality that the code of corporate should be dynamic and vibrant and it should consider the interest and expectation of all stakeholders and not only the shareholders. The committee noted that the aim of corporate governance is

¹⁷¹ N. Balasubramanian, “Ownership Trends in Corporate India 2001 – 2011 Evidence and Implications” http://www.iimb.ernet.in/research/sites/default/files/WP%20No.%20419_0.pdf (accessed May 23, 2015).

¹⁷² Pratip Kar, “Culture and Corporate Governance Principles in India: Reconcilable Clashes?” Private Sector Opinion (23 A Global Corporate Governance Forum Publication) http://www.ifc.org/wps/wcm/connect/1fe292804a4785e6824d9faa52ef3b86/PSO_23_Pratip.pdf?MOD=AJPERES (accessed May 23, 2015).

¹⁷³ Bernard S. Black and Vikramaditya S. Khanna, “Can Corporate Governance Reforms Increase Firm Market Values? Event Study Evidence from India” Journal of Empirical Legal Studies 4 (2007): 749–796.

¹⁷⁴ Chakrabarti, “Corporate Governance in India.”

enrichment of long term value and profit of shareholders while protecting the interests of other stakeholders than shareholders.¹⁷⁵

In keeping view the recommendation of said report the incorporation of clause 49 of listing agreement of SEBI was made that gave the statutory effect to the recommendations.¹⁷⁶ This clause 49 of listing agreement of SEBI guidelines also requires the listing companies to have a board composed of at least one third independent directors. Further it also requires public companies to have audit committees, “certification of financial statements and internal controls.”¹⁷⁷

In 2002 the Department of company affairs again “appointed a high level committee under the chairmanship of Naresh Chandra to examine the various corporate governance issues.”¹⁷⁸ This committee again made recommendation regarding managements and auditors to protect the all concerned stakeholders of the corporation. Subsequently, the ministry of Company affairs decided to amend the companies Act 1956 and revise it according to the suitable framework and to make such kind of regulations which can protect the stakeholders as whole and can meet the criterion and scenario of modern economies.¹⁷⁹ In pursuance of this report amendment was made in clause 49 listing agreement of SEBI and the professionals and management was held responsible to increase the wealth of corporation in keeping view the interest of all stakeholders

¹⁷⁵ R. M. Srivastava, Shubhra Verma, *Strategic Management: Concepts, Skills and Practices* (New Delhi: PHI learning Private Limited, 2012), 100.

¹⁷⁶ Jayati Sarkar and Subrata Sarkar, *Corporate Governance in India* (New Delhi: Sage Publication India Pvt Ltd, 2012), 19.

¹⁷⁷ Black, “Can Corporate Governance Reforms Increase Firm Market Values” 749–796.

¹⁷⁸ <http://ideaix03.ide.go.jp/English/Publish/Als/pdf/25.pdf> (accessed: December 12, 2014).

¹⁷⁹ Chris A. Mallin, *Handbook on International Corporate Governance: Country Analyses* (Cheltenham: Edward Elgar Publishing Limited, 2011), 424.

of the company.¹⁸⁰ Therefore, all above mentioned efforts and legal reforms in code of best practices for corporations are evident that Indian corporate culture and environment is also moving towards to some extent convergence towards stakeholder theory or model of governance.

¹⁸⁰ N. Gopalsamy, *A Guide to Corporate Governance* (Delhi: New International Pvt Ltd Publishers, 2006), 133.

CHAPTER 5:

CORPORATE GOVERNANCE IN PAKISTAN

5.1. INTRODUCTION:

The stakeholder theory gained much attention since its emergence. However, after the big corporate collapses in US, UK and Asia the convergence of stakeholder theory and its adverse shareholder theory become a hot debate all over the world. Therefore, Pakistani corporate sector has also ultimate effect of these changes and convergence of corporate theories and it needs to meet the expectations of foreign investor according to the international standards. In this chapter after a brief note regarding corporate governance growth in Pakistan we will analyze the corporate culture and legal structure of Pakistani corporations and ownership structure of Pakistani listed corporations. The Pakistan comes under the ambit of Anglo Saxon Approach.¹⁸¹ Therefore, its shareholder oriented model of corporate governance would also be examined. It will also bring under discussion that whether shareholder primacy model of governance is capable to stable its economy and to protect the long term value of shareholders while neglecting the stakeholders. Moreover, it would also be assessed that while the Pakistan has common law origin and at this instant the common law or Anglo Saxon countries particularly UK is also converging towards enlightened shareholder model or hybrid model then why Pakistan would not go towards corporate legal reforms accordingly so that it could meet the rapidly changing corporate environment of the world. Furthermore, the legal reforms will be suggested considering the convergence of corporate theories and its impact on Pakistan

¹⁸¹ Atiya Y. Javed, Robina Iqbal and Lubna Hasan, "Corporate Governance and Firm Performance: Evidence from Karachi Stock Exchange" The Pakistan Development Review 45 (2006) 947-964.

5.2. GROWTH OF CORPORATE GOVERNANCE IN PAKISTAN:

Corporate governance has received wide attention of policy makers in the developed and developing countries during the last decade. The significant dimension of corporate governance issues in a developing country like Pakistan, are under developed nature of corporate culture, family dominated business group, regional instability due to war and terror, and ineffective regulatory mechanism. This is a fact that family dominated corporate ownership structure prevails in Pakistan wherein the majority of companies or large number of business groups are held and controlled by family networks. Minorities' interests neither found a reasonable representation in corporate decision-making process nor corporate frame work protect them in form derivate-actions which are provided in British Company Act 2006. The behavioral patterns of corporate governance, such as, the actual conduct of corporations in terms of performance, efficiency, growth, financial structure, treatment of shareholders, role of institutional shareholders and corporate social responsibility are not yet well established.¹⁸²

There is evolving interest in the notion of corporate governance in Pakistan, as corporate governance is crucial to raise the market economy in progressing and transforming economies such as Pakistan.¹⁸³ Therefore, the East Asian financial crisis also attracted serious attention towards importance of corporate governance in developing countries including Pakistan. In pursuance of this purpose the regulatory body Security and Exchange Commission of Pakistan was established which has been governed by the Security and Exchange Commission of Pakistan Act 1997, and this regulatory body was became operational in 1999. The main objective behind

¹⁸² R.B Rasul2007 & 2008, "Regulatory Impact Assessment of SECP's Corporate Governance Code in Pakistan" Available at <file:///C:/Users/ComINN/Downloads/6256594.pdf>

¹⁸³ A Survey of Corporate Governance Practices in Pakistan" conducted by SECP, PICG and ACCA <http://www.picg.org.pk/admin/upload-report/Survey.pdf> (accessed May 23, 2015).

establishment of this regulatory body was to improve institutional framework as it would help in effective corporate governance and for economic development of Pakistan because strong regulatory institutional framework is crucial for economic development of any country.¹⁸⁴

The Security and Exchange Commission of Pakistan issued code of corporate governance in 2002¹⁸⁵ in order to boost the regulatory framework and to increase the shareholder value through its implementation, to improve transparency, governance and to protect the interest of shareholders by improving the disclosure in financial reporting of corporations. "Pakistan has developed good corporate governance laws but with poor implementation of these laws together with political instability that adversely affect corporate governance."¹⁸⁶ Thereafter, the revised code of corporate governance was published in 2012 which made the mandatory requirement of at least one independent director on the board.¹⁸⁷ Furthermore, the corporate governance rules were published by the SECP in 2013. The section 5 clause (c) of said corporate governance rules requires the management to maintain the good will of corporation by treating the general public, institutional investor and other stakeholder generously but it does not contain any provision or requirement regarding director's fiduciary duty towards stakeholders.¹⁸⁸ Another land mark development was made through establishment of Pakistan institute of corporate governance (PICG) in 2004, this institute was established as nonprofit organization and it was licensed under section 42 of companies Ordinance. The promoters of PICG are included SECP, SBP, corporate sector, stock exchanges and professional institutions. The objectives of PICG are to promote

¹⁸⁴ Attiya Y. Javid and Robina Iqbal "Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing" PIDE (2010): 1-81.

¹⁸⁵ ALI ADNAN IBRAHIM, "CORPORATE GOVERNANCE IN PAKISTAN: ANALYSIS OF CURRENT CHALLENGES AND RECOMMENDATIONS FOR FUTURE REFORMS"

<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan048461.pdf> last visited 01-08-2014

¹⁸⁶ Javid "Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing" 1-81.

¹⁸⁷ Code of Corporate Governance, 2012.

¹⁸⁸ Public Sector Companies (Corporate Governance) Rules, 2013.

awareness of corporate governance, to strengthen the compliance of corporate laws, rules and regulations by corporate bodies, and most particularly to "enhance accountability of management to stakeholders including members, employees, customers, suppliers and creditors of the corporations including environment."¹⁸⁹ The PICG also provides platform for research and development regarding corporate governance.¹⁹⁰

Thus, above mentioned developments witnessed that there are several efforts have been made towards implementation of corporate laws and to ensure fair corporate governance according to international standards. However, these corporate laws, regulations and its regulatory framework in Pakistan are legislated entirely to protect the interest of shareholders or investors and maximum protection has been given to the investors. The major law regarding corporations is Companies Ordinance 1984,¹⁹¹ therefore; it does not have any provision regarding the safeguard and protection of other stakeholders. On the other hand code of corporate governance also does not give emphasize on fiduciary duty of management and board of directors towards stakeholders other than shareholders. Therefore, no worth cited laws have been enacted regarding the protection of stakeholders including, creditors, employees, and suppliers. The whole structure and sole purpose of Pakistani corporate governance is to increase the profit and interest of shareholders or investors even it overlook the principle of long term value maximization which could only achieved through the protection of interest of corporation as whole.

¹⁸⁹ "Pakistan Institute of Corporate Governance (PICG).

¹⁹⁰ "A Survey of Corporate Governance Practices in Pakistan" conducted by SECP, PICG and ACCA <http://www.picg.org.pk/admin/upload-report/Survey.pdf> (accessed May 23, 2015).

¹⁹¹ The Companies Ordinance, 1984 (XLVII of 1984).

5.3. LEGAL STRUCTURE OF CORPORATIONS AND THEIR GOVERNANCE:

The Pakistani corporate ownership structure bears a resemblance to the concentrated family ownership structure. Furthermore, an empirical study conducted by PIDE regarding “value of ownership concentration for the sixty listed companies for year 2003-2007 proves that the more than 50 percent of the shares are owned by top three shareholders.”¹⁹² The local family owned business groups are the large shareholders therefore; this family controlled concentrated ownership structure of Pakistani corporations is far different from Berle & Means theory of separation of ownership and control. For instance, the large shareholders are not only holding the control of a company but they are managing it as well. As we have discussed above Pakistan has common law origin therefore, Pakistani corporate model stands on Anglo Saxon approach but on the other hand the ownership structure of Pakistani listed companies is contrary to the Anglo Saxon structure of dispersed ownership. Moreover, the legislative bodies of corporate laws for instance SECP have overlooked this distinction of ownership structure even the code of corporate governance has been issued after considering the UK initiatives regarding corporate governance. The family business groups controlled ownership structure is major reason to expropriate the rights of minority shareholders.¹⁹³ For instance, the section 290 of companies’ ordinance 1984 requires that shareholders holding below ten percent shares of whole company equity could not object the mismanagement and professional misconduct of management of company.¹⁹⁴ However, it is recognized principle of the world that the success of any company or institution is confined in the combine contribution and efforts of wide range of resources supplier

¹⁹² Javid, “Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing” 1-81.

¹⁹³ Ali Adnan Ibrahim, “Corporate Governance in Pakistan: Analysis of Current Challenges and Recommendations for Future Reforms” Washington University Global Studies Law Review 5 (2006): 323-332.

¹⁹⁴ Sec 290, Companies Ordinance, 1984.

like creditors, employees of the company. Consequently, the laws, rules and regulations regarding governance of corporations should be made after considering the present ownership structure of the Pakistani's companies.¹⁹⁵ Therefore, the unique institutional and corporate ownership structures of Pakistani corporations demand indigenous solutions to its indigenous problems of corporate governance. Furthermore, the policies and laws should be made according to the business context of Pakistan.

5.4. SHAREHOLDER ORIENTED MODEL OF CORPORATE GOVERNANCE IN PAKISTAN:

The Pakistani corporate governance model contains all the characteristics of shareholder oriented model of governance. As we discussed above there are "two features in any governance model that shape the interactions and relationships between the various parties in the governance process. First one is Board structure: the organizational framework the governing body operates under. Secondly is Board composition:"¹⁹⁶ who is represented on the governing body.¹⁹⁷ These two features also make distinction regarding theoretical philosophy of corporate governance model whether it is based on shareholder theory or stakeholder theory. In chapter three of instant research paper we have discussed in detail the key characteristics of both adverse model of corporate governance. If we examined the Pakistani corporate governance model on the pattern of those adverse models we could observe that the shareholder oriented model is followed in Pakistan. For instance, the unitary or one tier board of structure is applicable here. The employees and other stakeholders do not have any representation on board unlike to the stakeholder model of governance. In Pakistan there is no segregation between the supervisory

¹⁹⁵ Corporate scandals and need for corporate governance in Pakistan.

¹⁹⁶ <http://www.forumpartnerships.zsi.at/attach/MiguelMendezFinal.pdf> (accessed: January 13, 2014).

¹⁹⁷ See above chapter 3

and monitoring functions and the managerial functions. It is also point to be noted that the Pakistani ownership resembles to the concentrated ownership structure due to the family controlled companies and business groups. However, the evidences from UK and US found that the main feature of shareholder oriented model of governance is dispersed ownership structure including ownership of individuals, institutional investors and outsider shareholders.¹⁹⁸ Consequently, the Pakistani model of corporate governance is misfit to its indigenous corporate ownership structure and it needs further reforms. Furthermore, it does not have sufficient protection to the minority rights including stakeholders and it is proved by many empirical studies that in concentrated ownership systems the controlling shareholders may enrich themselves at the expense of the minority shareholders and other stakeholders.¹⁹⁹ Moreover, Pakistan does not have primary market structure unlike to the UK and initial public offering has been made through institutions and banks. Therefore, it is another flaw in the corporate structure of Pakistan which gives strength to the concentrated family controlled ownership structure and weaken the dispersed ownership.

5.5. WHETHER SHAREHOLDER PRIMACY IS BEST SUITED THEORY FOR PAKISTANI CORPORATE STRUCTURE?

The question regarding implementation of appropriate theory and corporate governance model in Pakistan is worth answering in current scenario. Although Pakistan has common law origin but its indigenous corporate culture, structure, problems and their solutions differ to the UK and US. The sustainable growth of economy and confidence in national economy could only be achieved through applicability and implementation of appropriate corporate model of governance and

¹⁹⁸ Saifdar Hussain Tahir et al, "Two-Tier Corporate Governance Model for Pakistan" European Journal of Business and Management 4 (2012) 38-47.

¹⁹⁹ Owen, "Corporate Governance," 53.

corporate laws accordingly. The concentrated family controlled corporate ownership structure along with maximum protection to large shareholders are witness that the policy makers and legislatures are only considering the rights of large controlling shareholders while making and legislating the laws regarding corporate governance. It is also worth mentioning that the Pakistan with concentrated corporate structure has minimum number of large shareholders of companies enlisted on stock exchanges but on the other hand it has maximum number of stakeholders including employees, creditors, suppliers, consumers and others. Therefore, within the Pakistani corporate domain the sufficient legal protection is only provided to the shareholders and other large number of stakeholders is not protected under law even minority shareholders have been neglected as well. Furthermore, the family owned corporations in Pakistan exercise "their political and bureaucratic influence in financial institution to take the overvalued heavy loans for their companies and utilize this credit money for their personal benefits and take the shield of corporate personality as a legal entity in case of insolvency to protect them from personal liability."²⁰⁰ The deficient protection has been given to the creditors to protect their interest in case of insolvency proceedings.

Although shareholder primacy theory is attractive for the investors but it requires active corporate monitoring for which the institutional shareholders can play important role. However, the free and fair functioning of institutional investors requires comprehensive review of their legal framework because the institutional shareholders (such as pension funds, insurance companies, investment companies and unit-trusts) in Pakistan are working under the shadow of federal government. Their functioning should be independent without bureaucratic interference

²⁰⁰ Ibid.

for healthy functioning of major shareholders.²⁰¹ However, the stakeholder theory may also be applied to provide job security to the corporate employees through services laws as well as to the general community through consumers' protection laws. The fiduciaries duties of the corporate directors and right of derivative actions for the protection of minority shareholders also need further reforms and clarification. Therefore, Pakistani corporate sector is in dire need to make legal reforms regarding corporate governance laws while considering its indigenous problems, business context and ownership structure.

5.6. CONVERGENCE OF CORPORATE THEORIES AND ITS IMPACT ON PAKISTAN:

The protracted convergence of corporate theories all over the world has set up the new trend towards reforms and legislation of corporate laws according to the contemporary issues of corporate governance. Pakistani corporate sector is confronting high family controlled ownership concentration, primitive capital markets, "easy availability of bank credit and subsequent default culture, and poor labour conditions."²⁰² The existence of all these factors and dynamics suggest that the Anglo-American shareholder model of corporate governance based on shareholder theory and agency based philosophy of market efficiency could not be entirely suitable for Pakistan. Furthermore, shareholder theory and agency based notion is not appropriate for Pakistani corporate sector due to the reason that the large controlling shareholders are dynamically engaged in the management of the company. Therefore, the agency problem related to the dispersion of ownership and control is ceased to exist due to the active role of large

²⁰¹ R.B Rasul2007 & 2008, "Regulatory Impact Assessment of SECP's Corporate Governance Code in Pakistan" Available at < file:///C:/Users/ComINN/Downloads/6256594.pdf> last accessed 11-08 2014

²⁰² Javed Siddiqui, "Development of Corporate Governance Regulations: The Case of an Emerging Economy," *Journal of Business Ethics*, 04 (2009).

shareholders in management. However, unlike to the UK there is another type of agency problem exist which can be described as relationship between large controlling ownership and minority shareholders.²⁰³ We have analyzed that the Pakistan corporate sector have indigenous problems and issues according to its corporate culture, corporate ownership structure and market structure which are far different from UK and US. We have also observed that how most developed countries of the world are moving towards hybrid model and convergence of corporate theories according to their indigenous problems and needs.²⁰⁴

The globalization of the world has strong impact on dispersing ownership of corporations. Therefore, the Pakistani corporate markets also need to attract the foreign investors but it could only possible after the adoption of suitable corporate model which can provide maximum protection to investors while providing the sufficient protection to large number of stakeholders. It is also point to be noted that all countries whether they are under the domain of shareholder model or stakeholder model; they all are converging towards balance model. For instance, legal reforms of UK and US including Germany all have evidence of convergence as we analyzed above.²⁰⁵ Moreover, Pakistan has common law origin and following Anglo Saxon model of governance blindly without considering its corporate culture and ownership structure. However, the constant convergence in the UK company law after the incorporation of section 172 of company law 1956, it has become great matter of concern why Pakistani corporate policy makers are following the pragmatic approach even the philosophy or origin to whom they are following is also changing and converging towards hybrid model after considering contemporary corporate

²⁰³ Kurt A. Desender, "The relationship between the ownership structure and the role of the board" University of Illinois at Urbana-Champaign

http://business.illinois.edu/working_papers/papers/09-0105.pdf (accessed August 12, 2014).

²⁰⁴ See chapter 4.

²⁰⁵ See chapter 4.

issues. Furthermore, we can consider the German corporate model with concentrated ownership as worth mentioning example of stakeholder model however, at the present scenario of the corporate world we certainly observe the minor but significant changes and legal reforms in the German corporate law regarding convergence of shareholder model of governance. For instance, the shareholder theory is now commonly used in large German corporations as many big corporations have made arrangements regarding investor relations departments on the pattern of Anglo-Saxon. Moreover, many large corporations have also adopted international accounting standard to gain the trust of foreign investors.²⁰⁶ Therefore, Pakistan also needs to gain experience from other developed economies and their contemporary reforms while considering its regional and indigenous issues of corporate sector.

5.7. WHETHER CORPORATE SECTOR NEEDS REFORMS FOR SUITABLE INVESTMENT CLIMATE?

The Pakistani ownership structure, pragmatic corporate culture, lack of law regarding protection of stakeholders and other contemporary issues of corporate governance are major factors to lead towards legal reforms. These legal reforms should be beneficial for shareholders including foreign investors and stakeholders as well.

Pakistan being a developing country needs foreign investment for its development and for purpose to encounter the investment gap. Therefore, sound corporate policies and investment climate is very crucial to attract the direct foreign investment. There are large numbers of economists who consider that the FDI is important as domestic investment for sustainable

²⁰⁶ Edwards "Corporate governance, industrial relations and trends in company-level restructuring in Europe," 518-535.

economic growth of any developing country.²⁰⁷ Moreover, the factors causing their influence to investment decisions by multinational corporations or investors are changing. While in quest of business opportunities, investors are “now more concerned about financial and political risks, with a focus on stable and predictable business environments.”²⁰⁸ Consequently, the developing economies all over the world recognize that “their chances of attracting more foreign investment depend on making their investment climates more competitive.”²⁰⁹ However, taking into consideration the current corporate governance model Pakistan we are able to protect the domestic investors and could make more attractive rules and regulation for foreign investor as well regarding their protection on the notion of shareholder theory but the question is how could we protect the domestic stakeholders in present situation of increasing FDI. It follows that Pakistan is in dire need to make reforms in corporate governance model so that it could equally protect the shareholders and stakeholders interest because FDI cannot be much productive for any developing country in absence of sufficient legal framework for domestic stakeholders. Therefore, in Pakistan it is imperative to care about the domestic stakeholders during policy making for corporate governance model. Hence, the example of German model of corporate governance is much attractive for the family controlled concentrated ownership structure of Pakistani corporation whereas Pakistani policy makers could also make arrangement on the basis of converging shareholder and stakeholder models which lead towards hybrid model. The adoption of hybrid model could become the guarantor to achieve the trust of foreign investor and to protect the interest of stakeholders at large as well. It would become the source to sustain the

²⁰⁷ Muhammad Azam, “Significance of Foreign Direct Investment in the Economic Development of Pakistan and Afghanistan” Central Asia Journal 64. http://www.asc-centralasia.edu.pk/Issue_64/03_Significance_of_Foreign_Direct.html (accessed May 23, 2015).

²⁰⁸ “Investing Across Borders 2010, Indicators of foreign direct investment regulation in 87 economies” The report is published by Investment Climate Advisory Services I World Bank Group; can be accessed at <http://iab.worldbank.org/~media/FPDKM/IAB/Documents/IAB-report.pdf> (accessed August 11, 2014).

²⁰⁹

economic growth of country and keep going business in the capital market. The hybrid model might become the tool to meet the world governance index. For instance the WGI is index developed by the World Bank shows that the best performer in corporate governance is Germany with a score of 90.8 percent.²¹⁰ Pakistan should also ponder the need of legal reforms to create a suitable investment climate for better growth of economy and it would be also helpful to increase the market business in Pakistan.

5.8. RECOMMENDATIONS FOR LEGAL REFORMS:

In above mentioned discussion we have found the issues and gaps in Pakistani legal framework regarding corporate governance model particularly in context of stakeholder's protection. Consequently, in that perspective it is very crucial to make legal reforms and try to combine and make rules and regulations on the basis of two different approaches of shareholder primacy and stakeholder theory. Therefore, following are the some recommendations and suggestions for legal reforms taking into account the Pakistani corporate culture, ownership structure and native contemporary issues of corporate governance.

- 1) Corporate governance model in Pakistan is based on shareholder theory following the corporate governance model and approach of common law. Whereas, corporate ownership is very concentrated in Pakistan and the main owners are local family-controlled business groups and the state. Therefore, separation of ownership and control is not much practical in present corporate structure of Pakistan. The present mechanism and concentrated ownership structure in Pakistan makes it easier to expropriate the minority shareholders and stakeholders of the firm. The stakeholder holders of corporations be given representation on

²¹⁰ Ramiz ur Rehman, "Corporate Governance and Performance of Financial Institutions in Pakistan: A Comparison between Conventional and Islamic Banks in Pakistan" The Pakistan Development Review 49 (2010) 461-475.

board like stakeholder model of corporate governance because if the decision making of corporations effect the large number of stakeholders then it seems very rational to give them representations and decision making rights. The representations of stakeholders on board can also contribute in improvement of working conditions which ultimately will lead to the better performance of corporation as whole.

- 2) This is the time to formulate the policy of corporate governance that should be competitive for corporate stability and investment. The lawmakers do not forget this fact that the shareholders of public corporations are minimum in number than stakeholders. The Pakistani corporate laws have been legislated considering the shareholder theory and the laws are only providing protection to the shareholders. There should be provisions in law for the protection of stakeholders particularly primary stakeholders like creditors and employees. The provision of law needs to be incorporated regarding fiduciary duties of directors toward stakeholders. The directors and management be made responsible to make effort for the progress of corporation and to protect the interest of stakeholders including shareholders as whole. The regulatory authority, policy makers and corporate community should also be clear that the new corporate legal framework in Pakistan should not only be attractive for the investors but it should provide security to the stakeholders through services mechanism.
- 3) The transformation of shareholder model into hybrid model can play vital role in sustainability and progress of economy. It is the best option considering the indigenous corporate culture and concentrated ownership structure of our country. The hybrid model of corporate governance can not only grant maximum protection to the investors/shareholder but can also protect and supervise the interest of minority shareholders and stakeholders. In present scenario of Pakistan we have minimum numbers of shareholders than stakeholders

like employees, creditors, customers, suppliers. Therefore, the legislatures are required to formulate the mechanism and structure that can protect the interest of stakeholders as whole. We have large numbers of foreign invested corporation listed on stock exchange it depicts that currently we have laws for protection of foreign investor/ shareholder but the interest domestic minority shareholders and stakeholders has not been addressed on satisfactory level. The corporate legislation should be made considering the notion of enlightened shareholder theory and structure of hybrid model of corporate governance. The adoption of hybrid model could become the guarantor to achieve the trust of foreign investor and to protect the interest of stakeholders at large as well. It would become the source to sustain the economic growth of country and keep going business in the capital market

- 4) The group of stakeholders should be categorized into primary and secondary stakeholders considering their priorities and demands and laws should be legislated accordingly. For example, there is special legislation is required for protection of creditors in case of insolvency of corporation. Directors should also be held responsible directly to the creditors ignoring the fact that corporation is factious person and has independent personality. Moreover, in recent years corporations have greatly increased the amount of resources allocated to activities classified as Corporate Social Responsibility (CSR). If the corporations be encouraged to spend these amount resources for protection and benefit of stakeholders it will result into better corporate performance of corporation as whole. Building better relations with primary stakeholders like “employees, customers, suppliers, and communities could lead to increased shareholder wealth by helping firms develop intangible, valuable assets which can be sources of competitive advantage. On the other hand, using corporate

resources for social issues not related to primary stakeholders may not create value for shareholders.”²¹¹

5) The theory of property rights should be implemented in manners that the employees' rights to their labor, the consumers' rights to their wealth and the communities' rights to public goods should also be treated and protected in same manners as property rights of shareholders being owner. It will lead towards stability and progress of the corporation as whole. The notion that purpose of corporation is only to maximize the wealth of shareholders should be succeeded by protecting the interest of all stakeholders. To protect the interest of corporation as whole will achieve the long term maximization of wealth.

5.9. CONCLUSION:

In this paper we examined the two opposite theories of corporate governance and corporate models of governance based on said theories. In present scenario of corporate world the convergence of shareholder corporate model and stakeholder corporate has also been analyzed. Our analysis suggests that the current corporate governance model of Pakistan should be transformed into hybrid model of corporate governance considering the concentrated corporate structure, indigenous corporate issues and maximum number of domestic stakeholders. The legislation regarding representation of stakeholders on board of directors and fiduciary duty of directors towards stakeholders as whole will lead to better financial performance of corporation. The unique institutional and corporate ownership structures of Pakistani corporations demand indigenous solutions to its indigenous problems. It does not argue that the hybrid model of corporate governance can necessarily result in a stable system because the change in corporate governance is not supposed to be end as new developments take place every day. The policy

²¹¹ Hillman, Amy J., and Gerald D. Kei., "Shareholder value, stakeholder management, and social issues: what's the bottom line?," *Strategic management journal* 22 (2001): 125-139.

makers are only need to come out from pragmatic approach of shareholder theory and transformed the corporate laws according to the contemporary issues.

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