

Shareholding Versus Stakeholding: a critical review of corporate governance

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The current debate and theorising on corporate governance has been polarised between a shareholder perspective and a stakeholder perspective. 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 presuppositions 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 theorising. It calls for a new mode of thinking in analysing corporate governance and concludes by outlining a new direction of research in this field.

Keywords: Shareholding, stakeholding, corporate governance, modes of thought, dichotomy, critical review

Introduction

Much of the current debate on corporate governance has centred on practical issues, including corporate fraud, the abuse of managerial power and social irresponsibility. In essence, the debate is about how to solve these perceived problems in corporate practice. For many commentators corporate governance is about building effective mechanisms and measures, either in order to satisfy current social expectations or to satisfy the narrower expectations of shareholders. In the UK, several influential proposals have been produced in recent years in an attempt to settle the practical issues (Cadbury Committee, 1992; Greenbury Committee, 1995; Hampel Committee, 1998; Turnbull Committee, 1999; Higgs 2003). In conjunction with the practical debate sits a debate on the theoretical framework and the quest for the optimal or superior theoretical model of corporate

governance. The debate has touched many deep-seated, fundamental questions, for example what is the purpose of the corporation? In whose interest is the corporation run? Who should control the corporation? How should they control it? In general, corporate governance is about the understanding and institutional arrangements for relationships among various economic actors and corporate participants who may have direct or indirect interests in a corporation, such as shareholders, directors/managers, employees, creditors, suppliers, customers, local communities, government, and the general public (see Figure 1). Different perspectives in theory result in different diagnoses of and solutions to the problems of corporate governance practice.

Some current perspectives on corporate governance have been categorised into two contrasting paradigms: shareholding and stakeholding (see, for example, O'Sullivan, 2000;

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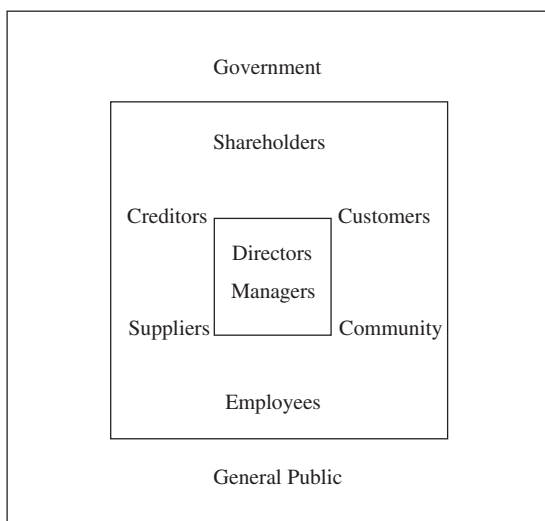


Figure 1: Relationships in corporate governance

Kakabadse and Kakabadse, 2001; Friedman and Miles, 2002). Such a division hinges on the purpose of the corporation and its associated structure of governance arrangements understood and justified in theory. On the one side is the traditional shareholding perspective, which regards the corporation as a legal instrument for shareholders to maximise their own interests – investment returns. A three-tier hierarchal governance structure, i.e. the shareholder general meeting, the board of directors and executive managers, is given in company law in an attempt to secure shareholders' interest (it is often called the mechanism of "checks and balances"). On the other side is the stakeholding perspective newly emerged in the later 20th century, which positions itself on the contrary to the traditional wisdom and views the corporation as a locus in relation to wider external stakeholders' interests rather than merely shareholders' wealth. Employees, creditors, suppliers, customers and the local community are major stakeholders often mentioned and emphasised within a broad definition of stakeholding (e.g. Freeman, 1984). Stakeholders' participation in corporate decision-makings, long-term contractual associations between the firm and stakeholders, trust relationships and business ethics are the main proposals for stakeholding management.

Current analyses on corporate governance draw more attention to evaluating and judging the superiority of either the shareholder model or stakeholder model and often take part in one-sided arguments, sometimes with a slight modification such as an enlightened shareholder model (see Gamble and Kelly, 2001) and an enlightened stakeholder

model (Jensen, 2001). The analyses seldom step outside the narrow confines of their respective interests to investigate the theoretical genealogy, ideology, presuppositions and value systems behind and underpinning the perspectives or paradigms. This conventional approach constrains their views and raises serious questions as to the theoretical validity and credibility of these models. To understand the current fierce debate on corporate governance, it is important to stand back from the one-sided arguments with their taken-for-granted ideas. Reflexive thinking is needed through critical examination of the major theorems, assumptions and origins of both perspectives. This paper serves as a survey and critical review of both the shareholder and stakeholder perspectives on corporate governance. A major finding in this paper is that although the current prevailing analyses may have some merits and insights at a particular point in time, they are, however, over-abstracted and over-static in modelling and theorising corporate governance. They build their "rational" arguments and "ideal" models on traditional assumptions and theories that were generated and/or constructed in centuries-old societal contexts, far removed from the current modern business environment where, for example, the boundary of the firm has become blurred in terms of global markets and where physical assets are far less important than human resources, knowledge and information. They ignore the continuous change of natural and social realities and distance themselves from the dynamics of corporate governance in practice. The economic approach mostly employed in their analyses tends to be culture-free, historically separated and contextually unrelated. We note that very recent studies have seriously questioned the traditional theory of the firm and called for a new direction in building a new theory of the firm that reflects the modern day business environment (e.g., Zingales, 2000; Rajan and Zingales, 2000). Other studies in law, sociology, politics and culture in relation to corporate power and control may also offer some insights into rethinking corporate governance and overcome part of the shortcomings of current models. It is the conventional modes of thought and associated approaches such as dualism/dichotomy, idealism/perfectionism, universality and permanency that endorse and justify the polarised shareholding and stakeholding models.

This paper is structured as follows. In the next section current major theoretical models in corporate governance are summarised based on the mainstream typology. These models are presented as examples to indicate

how the two academic schools of shareholding and stakeholding have been divided into opposing camps. Following this, the major theorems and arguments of the shareholding and stakeholding perspectives are examined respectively, from which their basic assumptions and presuppositions are clearly observed. Attention is given to the shifting character of the corporate reality as well as the perspectives themselves, from which the superiority of both theoretical models is questioned. Recent new challenges to the traditional theory of the firm and stakeholder theory are reviewed. Finally, we conclude the paper with some remarks on the limitations of current approaches, particularly the conventional modes of thought, on analysing corporate governance issues and call for a new way of thinking. The conclusion of this paper is that modes of thought do matter in understanding corporate governance.

The corporate governance debate: shareholding vs stakeholding

As current analyses on corporate governance approach the governance issue from different perspectives and base their views on different assumptions and presuppositions, there exist quite diverse theoretical models which can be identified in the literature. Major surveys and/or reviews of corporate governance models have been conducted by Hawley and Williams (1996), Shleifer and Vishny (1997), Turnbull (1997b) and Keasey *et al.* (1997). Hawley and Williams (1996) suggest four major views in the corporate governance debate in the US, i.e. the finance model, the stewardship model, the stakeholder model and the political model. The dominant model in the late 20th century is the finance view of corporate governance, which is concerned with a universal agency problem and how to adopt appropriate incentive systems and/or the mechanism of takeover to solve this problem. While the finance model is focused on shareholder rights and control in publicly held corporations, Shleifer and Vishny (1997) extend the finance view of the firm to include not only shareholders, but also debt-holders and bankers. In contrast to the dominant finance model, the stewardship model (see Donaldson and Davis, 1994) assumes a different nature of agent/managerial behaviour and argues that managers are trustworthy and should be fully empowered. The stakeholder model further extends the purpose of the corporation from maximising shareholders wealth to delivering wider outputs to a range

of stakeholders and emphasises corporate efficiency in a social context. Departing from the prevailing economic analysis of corporate governance, the political model (e.g. Pound, 1992, 1993), according to Hawley and Williams (1996), is a non-market approach for monitoring management, such as shareholder democracy and negotiation. In Turnbull's (1997b) view, such a political model focuses only on the micro level of politics in corporations, the broader political context such as the political tradition, ideology, government intention, regulation and institution is considered elsewhere (e.g. Letza and Smallman, 2001). Turnbull also reviews other models based on culture, power and cybernetics, in addition to the above four models.

Based on Blair's (1995) taxonomy, Keasey *et al.* (1997) also summarise four competing models in the current studies of corporate governance, each with its own diagnosis of and solutions for the Anglo-American governance issues. The four schools of thought are the principal-agent or finance model, the myopic market model, the abuse of executive power model, and the stakeholder model. Here, the principal-agent or finance model and the stakeholder model are the same as those in the classification of Hawley and Williams, as mentioned above. In the view of the principal-agent or finance model (e.g. Manne, 1965; Jensen and Meckling, 1976), although the separation of ownership and control may provide the opportunities for managerial divergent behaviours from maximising shareholders' value, the markets – particularly the capital market, the managerial labour market and the market for corporate control – provide the most effective restraints on managerial discretion (note that this assumption is rejected by Pound (1992, 1993) for the reason that a new form of governance based on politics rather than finance would be more effective and less expensive). This school claims that corporate governance failures are best addressed by removing restrictions on factor markets and the market in corporate control, together with strengthening the incentive system (bonuses, stock options, etc.), introducing a voluntary code and appointing non-executive directors.

Though the myopic market model (e.g. Charkham, 1994; Sykes, 1994; Moreland, 1995) agrees with the principal-agent or finance model that the maximisation of shareholders' interests is the focus, it argues that the fundamental flaw of the Anglo-American corporate governance system is its excessive concern with short-term market value. Certain long-term expenditures, particularly capital investment and research and development

spending, are systematically undervalued by the markets because of the immediate pressure or interest from hostile takeovers. The short-sighted markets thus force otherwise diligent managers to concentrate solely on the current share price and ignore the long-term value creation of the firm, or take decisions against the threat of hostile takeover at the expense of shareholders interest. The solution for improving corporate governance is to provide an environment in which shareholders (particularly large and/or institutional shareholders) and managers are encouraged to share long-run performance horizons, such as increasing shareholders' loyalty and voice, reducing the shareholder exit, encouraging "relationship investing", and empowering other groups (employees, suppliers, etc.) to have long-term relationships with the firm.

Rejecting the principal-agent or finance model, the abuse of executive power model (e.g. Hutton, 1995; Kay and Silberston, 1995) claims that the purpose of a corporation is to serve the corporate interest as a whole. The major problem with the current corporate governance arrangements is that they allow excessive power to executive managers who may abuse their power in pursuit of their own interests. The supporters of this model argue that the current institutional restraints on managerial behaviour based on the notions of self-regulation and market discipline are ineffective and inadequate. They appeal for statutory changes in corporate governance, such as a fixed four-year term for chief executive officers, independent nomination of non-executive directors and more powers for non-executive directors.

The major challenge to the principal-agent or finance model stems from the stakeholder model (e.g. Freeman, 1984; Blair, 1995), which claims that the firm should serve wider interests of stakeholders rather than shareholders only. Stakeholders such as employees, creditors, suppliers, customers and local communities have long-term relationships (both contributions and risk-sharing) with the firm and affect its long-term success. Their welfare must be taken into account in corporate decision-making. This model argues that the current corporate governance system in the Anglo-American environment fails to encourage stakeholder involvement with the firm, including inter-firm cooperation and employee participation, which indicates a disadvantage of national performance and international competition, in comparison with the corporate governance structures in Germany and in Japan.¹

The above four models as presented in Keasey *et al.* (1997) have explored specific

issues in corporate governance issues, i.e. self-interest behaviour of agents, short-term market forces, the abuse of power by management and the neglect of stakeholders' involvement. Each model offers its own diagnosis as the "true" cause of corporate governance defects and based on the diagnosis each tries to search and find an optimal solution. They concentrate on the mechanisms of internal monitoring or external market discipline from which to prescribe peculiar recipes to treating the ailments. While the principal-agent model highly values the mechanism of market governance, the other three rely on non-market measures, such as shareholder loyalty and voice, institutional shareholders' monitoring, and independent non-executive directors' empowerment, and stakeholders' participation in decision-making. Table 1 summarises the main viewpoints and their contexts in the four models.

The above four models (and other mainstream models previously mentioned) are constructed as theoretical models and are primarily drawn from within the Anglo-American context. They do not purposefully cover all types of companies and all societies in the world, nor do they include all corporate governance and control studies (for more details on the limitations of the Hawley and Williams' perspective see Turnbull, 1997b). But what is significant is that these models represent a conventional mode of thinking about corporate governance, which has long been underlining and dominating our research, ideas and governance practices, and which can be found everywhere all over the world, not merely limited to the Anglo-American societies (although such a mode of thought can be found more easily and more explicitly in the Anglophone context). With the conventional mode of thought, all the theoretical models neatly fall within two opposing perspectives: the shareholder perspective and the stakeholder perspective. For example, the former two models in the above belong to a shareholder perspective as they share the common assumption that the purpose of corporations is the maximisation of shareholders' wealth. And the latter two commonly hold a stakeholder perspective, since both insist on a broad sense of stakeholding welfare. Such a convenient taxonomy has been used by O'Sullivan (2000) and Kakabadse and Kakabadse (2001), among others. It is notable that the separation and polarisation of shareholding and stakeholding is not only popular among scholars, but also among practitioners and societies. The fundamental issue behind the approach and associated modes of thought has not been recognised so far in the field of

Table 1: Summary of current mainstream corporate governance models

	The principal-agent or finance model	The myopic market model	The abuse of executive power model	The stakeholder model
Major contributor	Jensen and Meckling (1976); Manne (1965)	Charkham (1994); Sykes (1994)	Hutton (1995); Kay and Silberston (1995)	Freeman (1984); Blair (1995)
Purpose of corporation	Maximisation of shareholder wealth	Maximisation of shareholder wealth	Maximisation of corporate wealth as a whole	Maximisation of stakeholders' wealth
Problem of governance	Agency problem	Excessive concern with short-term market value	Abuse of executive power for their own interests	Absence of stakeholders' involvement
Cause	Shareholders do not have enough control	Ineffective market forces	Institutional arrangements leave excessive power to management	Governance failure to represent stakeholders' interests
Background	The separation of ownership from control	The takeover movement in the 1980s	Managerialism	Different styles of capitalism
Assumption about the causation	Self-interest human behaviour	Market dysfunction	Authoritarian governance	Traditional mentality of private ownership
Rejection	Any external interventions	Market governance	The principal-agent model	The principal-agent model
Proposition	Market efficiency	Importance of long-term relationship	Manager as trusteeship	Social efficiency of economy
Solution	<ul style="list-style-type: none"> • Removing restrictions on markets • Strengthening the incentive system • Introducing a voluntary code 	<ul style="list-style-type: none"> • Increasing shareholder loyalty and voice • Reducing the ease of shareholder exit • Encouraging relationship investing • Empowering long-term offer groups 	<ul style="list-style-type: none"> • Statutory changes in governance • Fixed four-year terms of CEO • Independent nomination of directors • Greater power of non-executive directors 	<ul style="list-style-type: none"> • Trust relationships and long-term contractual associations between the firm and stakeholders • Inter-firm cooperation • Employees' participation • Business ethics

Source: Based on Keasey *et al.* (1997), Blair (1995).

corporate governance. While the two main perspectives are deliberately duplicated in many studies, the theorems, origins, assumptions and theoretical contexts embedded in or behind the perspectives are less well examined and articulated in the literature. The validity of modes of thinking is rarely questioned. In general, the understanding of the debate and the models and perspectives of corporate governance are merely scratching the surface of

the subject. Therefore, in what follows, we attempt to capture the central arguments, core assumptions and philosophies of the shareholding and stakeholding perspectives respectively, from which the sharp differences on assumptions and presuppositions between the two perspectives are clearly observed. These analyses are necessary for our further questions about the current way of theorising in corporate governance.

The shareholding perspective: corporate governance as a private matter

The mentality of individual private property

The shareholding perspective as an orthodox and dominant approach to the understanding of corporate governance has its ideological and theoretical origin in the fundamental mentality of individual private ownership rights as the foundation of capitalism. The traditional wisdom is that private ownership is fundamental to a desirable social order and to the development of an efficient economy, and thus private ownership rights are inviolable to corporate governance (see Gamble and Kelly, 2001). Underlying the notion of private ownership is the ideology of individualism which emerged in England in the 15th and 16th centuries as a result of the emerging mercantilism and the Reformation and Renaissance which gradually broke from the old feudal society and required a new definition of social order and regulation. Individualism initially emphasised such conceptions as individual separation (with self-confidence, self-awareness and self-help), freedom (free mobility, free exchange and free competition) and autonomy (private contract, self-determination and self-regulation) (Macfarlane, 1978; see also Tricker, 2000). With the development of the capitalist economy during the 17th, 18th and 19th centuries, when incorporation began to emerge in England at first as a chartered form for overseas trading (such as the East India Company in 1600) and subsequently as a legislated form as a mechanism for raising capital and business expansion,² the individualist ideology was inherited by corporate law theory in interpreting the nature of incorporation. It was assumed that the right to incorporate is inherent in the right to own property and write contracts, and that the corporation is a legal extension of its owners – shareholders (see Allen, 1992). The inherent property rights theory also insisted that although a company is regarded as a legal person separate from its owners, the nature of shareholders as the company's owners never changes and the company is legally obliged to serve the interest of its shareholders (as the corporate members). Corporate property should be treated as a private association which demands the minimum of government regulation and interference (see Gamble and Kelly, 2001).

This theory obtained further support during a fierce debate in corporate law theory on the nature of corporate personality in the late 19th

century. One side of the debate is referred to as the aggregate or "fiction" theory, advocated by the German jurist Rudolf von Jhering (1818–1892) and the American jurist Wesley N. Hohfeld (1879–1918). That doctrine asserts that the corporation as a legal group is simply created by the state and is no more than a private association of shareholders. The new form of corporate property is the aggregation of individual property rights under a collective name, united by contract and protected by company law. Since shareholders are the owners of the corporation, the corporation has legitimate obligations and the managers have a fiduciary duty to act in the interest of shareholders (a summary of the above theory is shown in Table 2) (Barker, 1958; Mayson *et al.*, 1994).

In the 20th century, the traditional liberal and individualist approach to property and corporate governance was further justified in neoclassical economics along with the principle of free market, economic efficiency and profit maximisation. Hayek (1969), for example, argues that individuals owning private property and pursuing self-interests ensure the most efficient economic activities and outcomes. The corporation owned by shareholders must aim at maximising profits to enhance shareholders value. If a corporation acts for any social purpose beyond shareholders' interest, it will provide opportunities for managers to justify their abuse of power and for government to intervene in corporate decisions, which will lead to the allocation of corporate resources in an inefficient way. Friedman (1962, 1970) also asserts that the function of business in a society is to make profits in a free market for shareholders, which should not be confused with other social functions performed by governments, institutions and charities. The request for social responsibility of business is harmful to the foundations of a free society with a free-enterprise and private-property system. Thus, for Friedman, the only social responsibility of business is to increase its profits.

A universal agency problem

In the shareholding perspective, a basic issue in corporate governance is whether or not shareholders' interest can be effectively protected under the current institutional arrangements. Since shareholders have to delegate control to a few directors and managers to run the company on behalf of all the shareholders, there is a potential risk that directors and managers may serve their own interests at the expense of all the shareholders. This problem was initially identified by Adam Smith in 1776

Table 2: Contrasting views in the 19th century's debate on corporate governance

Major theories	Inherent property rights theory (also the fiction theory)	Social entity theory (also the organic theory)
Nature of corporation	Association of shareholders	Independent legal person
Purpose	Shareholders' interest	Social/corporate interest
Objective	Profit maximisation	Long-term growth
Ownership	Private property/individual rights	Corporate property/collective rights
Legal instrument	Contract	Law
Regulation	Self-regulation	Legislation/state intervene
Governance structure	Internal monitoring: managers as agents with fiduciary duty and accountability	Internal monitoring: managers as organs/representatives with loyalty, authority and social responsibility
Legal system	Anglo-American legal system	Continent-European legal system

Source: Based on Allen (1992), Mayson *et al.* (1994).

(1937), who noted that the directors in a joint-stock company could not be expected to be as vigilant and careful with other people's money as they are with their own. Management's potential negligence and profusion always prevail as an issue in public companies. This problem has become wider and more serious since the early 20th century, as the separation of ownership and control increased the power of professional managers and leaves them free to pursue their own interests (Berle and Means, 1932). Concerned with this issue, agency theory was built by Jensen and Meckling (1976), among others, in the 1970s, employed for their diagnosis of and solution to the corporate governance ailments.

Beginning with the aged assumption of the nature of self-interest human behaviour, which intrinsically underpins individualism and classical and neoclassical economics, agency theorists assert that the agency problem can occur in all cooperative efforts where there exist principal-agent relationships, namely, in all organisations and at every level of management in organisations (Jensen and Meckling, 1976, p. 309). This implies that managers as agents may naturally use the delegated power in their hands to maximise their own utility instead of shareholders/principals' welfare. Therefore, managers are basically untrustworthy and must be fully monitored. There are two issues occurring in the agency relationship with which agency theory is concerned. The first is that because it is difficult or expensive for the principal to know the performance of the agent, the principal cannot verify that the agent has behaved

appropriately. The second issue is that the principal and the agent may prefer different actions because of the different attitudes toward risk (Eisenhardt, 1989, p. 58). Those two problems incur a particular type of management cost – "agency cost" – as principals/owners attempt to ensure that agents/managers act in the principals' interests (Jensen and Meckling, 1976). The best solution to those problems is to determine the most efficient contract governing the principal-agent relationship and an optimal incentive scheme to align the behaviour of the managers with the interest of owners.

The concept of contract is the most favoured metaphor used in agency theory. It believes that all social relations in economic interaction are reducible to a set of contracts between principals and agents. The role of contracts serves as a vehicle for voluntary exchange (Alchian and Demsetz, 1972). The firm can be best viewed as a "nexus of contracts" and contractual relations exist not only between shareholders, but also with all other stakeholders (Jensen and Meckling, 1976). But only shareholders have profit incentive and investment-risk awareness to ensure the most efficient and effective governance arrangements to protect their interests (see Dallas, 1988, p. 24). To align the interest of the agent with that of the principal, a complete contract containing specifications of the agent duties, rewards and the rights of the principal to monitor their performance is required (see Fligstein and Freeland, 1995, p. 26). According to the proponents of principal-agent theory, adopting appropriate incentive systems to reward managers is a key solution to the agency problem.

The focus of agency theory is on determining the most efficient contract governing the principal-agent relationship. An optimal choice between a behaviour-oriented contract (e.g. salaries, hierarchical governance) and an outcome-oriented contract (e.g. commissions, stock options, transfer of property rights) becomes critical (Eisenhardt, 1989, p. 58). It ultimately depends on the trade-off calculation between the cost of measuring behaviour (through purchasing complete information and rewarding hard-working behaviours) and the cost of measuring outcomes (e.g. profitability) and transferring risk to the agent (Eisenhardt, 1985, p. 136).

While agency theory focuses on writing complete contracts and implementing effective monitoring to secure shareholders' interest, it also views the managerial labour market as a disciplinary tool on managerial misbehaviour. There exists both external managerial labour market (each manager's outside opportunity wage is determined by the performance of the firm) and internal managerial labour market (top managers in a firm compete to become the boss of the bosses), which can effectively discipline managers who may have incentive to expropriate shareholders wealth (Fama, 1980).

Market efficiency and market governance

Within the shareholding camp, there is an argument on how to solve the agency problem. Like all bureaucratic organisations, a hierarchical check and balance mechanism was designed in company law, which includes the three-tier structure – the shareholders' general meeting, the board of directors and executive managers. However, in the 20th century, with the increasing separation of ownership and control within the Anglo-American culture, shareholders' internal monitoring became less effective. Under these circumstances, many financial economists advocate that market governance is the most effective mechanism, because the pressure of capital markets and takeovers can heavily discipline managerial discretion of deviating from shareholders value of profit maximisation (Alchian and Kessel, 1962; Manne, 1965). The rationale behind the finance model of corporate governance is a theorem prevailing in financial economics, which assumes that the share price today fully reflects the market value of all future profits and growth that will accrue to the company. Thus, the advocates of the "market for corporate control" hold that shareholders wealth is best served by maximising share price; unfortunately this tends towards the short run. The share price is an

indicator of corporate performance and the stock market is the only objective evaluation of management performance. If a firm underperforms its share price will drop, which provides a chance for outsiders to purchase the firm's stock at a lower price and run the firm more efficiently in order to obtain a greater reward. The threat of a takeover forces management to make efforts for better performance and maximise shareholders' return in order to prevent takeover.

Supporters of the finance model argue that corporate governance failure can be best addressed by removing restrictions on factor markets and the market for corporate control (Fama, 1980). Shareholders' voting rights on takeover should be enhanced. Any external interventions and additional obligations imposed on corporations may distort free market mechanisms and thus should be avoided (Hart, 1995). Self-regulation, as well as some additional measures without compulsion, such as a voluntary code (Cadbury Committee, 1992), is more efficient than any legislative change.

Controvertible marketisation

The market solution to corporate governance problems is, however, rejected by another school of thought, the myopic market model (Blair, 1995; Keasey *et al.*, 1997). Sharing the common position of the shareholding perspective, the myopic market model argues that the Anglo-American model of corporate governance is fundamentally flawed by an over concern with short-termism due to huge market pressures – short-term return on investment, short-term corporate profits, short-term management performance, short-term stock market prices and short-term expenditures. Thus, the most serious problem with corporate governance is that the current institutional arrangement encourages managers to focus on short-term profit return (even less than half a year) by sacrificing long-term value (e.g. R&D investment) and competitive capacity of the corporation (e.g. Hayes and Abernathy, 1980; Charkham, 1994; Sykes, 1994; Moreland, 1995). It is argued that the stock market is not a good indicator of corporate performance because it is unable to cope with uncertainty and often misprices assets. The share prices can change without any corresponding change in corporate fundamental values and may simply result from guesses about the behaviour and psychology of market participants and the changing moods and prejudices of investors (Keynes, 1936; Shiller, 1989). Therefore, the market for corporate control is not an efficient disciplinary

mechanism. The threat of hostile takeover may distort and distract from true value creation as managers may be forced to act against hostile takeover at the expense of corporate wealth.

The myopic market model turns back to internal mechanisms, rather than external markets, for effective corporate governance by stressing long-term economic relationships and long-run corporate performance horizons shared by shareholders and managers. Shareholders' loyalty and voice rather than exit should be encouraged. The takeover process and shareholders' voting rights for short-term return should be restricted (see Keasey *et al.*, 1997).

The stakeholding perspective: stakeholder interest as end or means

The corporation as a social entity

Stakeholder theory has been categorised into three aspects, i.e. normative, instrumental, and descriptive, based on their different research approaches (Donaldson and Preston, 1995). Two types of main stakeholder theory can be identified – the normative stakeholder theory and the instrumental stakeholder theory. While the former emphasises “intrinsic value” in stakeholding and views stakeholders as “end”, the latter is only interested in how stakeholders' value can be used for improving corporate performance and efficiency and regards stakeholders as “means”. In corporate governance, the normative stakeholder theory has its origin in the social entity conception of the corporation, as developed in the later part of the 19th century. It was observed that the modern corporation had large scale and scope that required distinctive professional management expertise and a great amount of capital investments. Through stock markets, share ownership in a corporation become dispersed and fragmented and shareholders are more like investors rather than owners. Since corporations are involved in many aspects of social life and affect many people in both welfare and potential risks, a public corporation should be conscious of its social obligations such as fairness, social justice and protection of employees. In this regard, corporations became more like independent entities with their own purpose, their own properties and their own duties (see Allen, 1992).

This view is strongly supported by corporate law theory in which the corporation is defined as a legal person separate from its members.³ In the debate against the aggregate or “fiction” theory as mentioned previously,

there emerged a “nature-entity” or “organic” theory, which is particularly associated with the German legal historian Otto von Gierke (1841–1921). This theory asserts that an association of persons has a real personality that is not fictionally created by the state or law, but really existent and recognised by the group in the process of incorporation. The law simply found the existence of the group or association and endowed it with a corporate personality with legal powers. Thus, the corporation as a real, rather than an artificial, person is not the aggregation of its members and individual rights. It has a distinctive mind/will and capacity to act, has its own rights and duties, and is responsible for its own actions and their consequences. Individuals in the corporation carry out duties and other activities and as such are not acting as independent persons but as organs of the corporate person (for a summary of the above theory, see Table 2) (see Barker, 1958; Arthur, 1987; Mayson *et al.*, 1994).

Based on the grounds of fundamental value and moral order of the community, the social entity theory views the corporation as a social institution in society. As Sacks (1997) posits, our attachments and affiliations, loyalties and loves are both moral and fundamental: “they enter into our identity, our understanding of the specific person we are” and “they cannot be reduced to contractual alliances for the temporary pursuit of gain” (quoted in Warren, 2000, p. 130). The justification of “intrinsic value” as good or morally right and ideal does not necessarily depend on factual reasons, but rather on an emotional faith and social belief (Campbell, 1997, p. 446; Stoney and Winstanley, 2001, p. 608). It is argued that corporations are granted by the state not only as an economic entity for a commercial purpose but, more importantly, as a social entity for general community needs such as “honouring individual dignity and promoting overall welfare” (Sullivan and Conlon, 1997, p. 713). The corporation has a collective rather than individual identity and executives are representatives and guardians of all corporate stakeholders' interests (Hall, 1989). To resolve disputes and conflicts of interests and overcome market failures and transaction costs, legal intervention within a public law framework and an improved system of checks and balances are necessary (Millon, 1990; Allen, 1995).

In recent years, several concepts or perspectives advocated are linked to the social entity conception of the corporation, such as economic democracy promoted by democratic political theorist Robert Dahl (1985), associationalism by Paul Hirst (1994), and communitarian notion of property by Jonathan Boswell

(1990) (see Warren, 2000, pp. 130–142). The recent resurgence of the normative or moral aspect of stakeholder perspectives (e.g. Handy, 1993, 1997; Carroll, 1991, 1996) has in general reflected the social entity conception of the corporation.

The instrumentality of stakeholding

The most popular perspective in stakeholder theory is the instrumental stakeholder theory promoted by economists and others (e.g. Cadbury Committee, 1992; Parkinson, 1995; Campbell, 1997; Plender, 1997; Centre for Tomorrow's Corporation, 1998; Slinger, 1998). It holds the same claim as the social entity theory, that a corporation should serve multiple interests of stakeholders, rather than shareholder interest alone, in order to make the corporation more legitimate. Unlike social entity theory that justifies stakeholder interests on the basis of moral value and fundamental human rights, the instrumental stakeholder theory legitimises stakeholder value on the grounds of stakeholding as an effective means to improve efficiency, profitability, competition and economic success. As Campbell explicitly posits, "I support stakeholder theory not from some left wing reason of equity, but because I believe it to be fundamental to understanding how to make money in business" (1997, p. 446). Freeman's (1984) initiative on stakeholder management as a business strategy also has an instrumental orientation. He argues that as the forces of stakeholder groups such as stockholders, lenders, customers, employees, suppliers and management are increasingly and vitally affecting business success and corporate survival, corporate strategy must sensitise this change and ensure that stakeholder interests are incorporated into, rather than ignored, in corporate strategy. In recent years, stakeholder theory has been associated with a political position such as New Left (Stoney and Winstanley, 2001) and has tended to be seen as a reconciliation of the competing claims of economic efficiency and social justice (O'Sullivan, 2000). However, the final end of justification is still instrumental. For example, in the book *Stakeholder Capitalism* edited by Kelly *et al.*, stakeholder theory is based on the grounds that

Individuals well endowed with economic and social capabilities will be more productive; companies which draw on the experience of all of their stakeholders will be more efficient; while social cohesion within a nation is increasingly seen as a requirement for international competitiveness. (Kelly et al., 1997, p. 244)

This line of stakeholding theory views its instrumentality as "intrinsic value" which is more attuned to the traditional Anglo-American corporate governance mentality of private ownership (Gamble and Kelly, 2001). It suggests that corporate governance should not depart from ownership rights, but that such rights should not be solely claimed by, and thus concentrated in, shareholders; ownership rights can also be claimed by other stakeholders, particularly employees. Turnbull (1994, 1997a, 1998), for example, advocates stakeholder ownership and governance in line with a property rights analysis. He suggests that a perpetual shareholder ownership permits investors to be overpaid, which "is inconsistent with either economic efficiency or social equity" (1997a, pp. 11–12). He also supports stakeholder theory from a cybernetic perspective, and claims that stakeholder participation in corporate governance can generate more accurate and unbiased information for business operation and management and thus improve governing efficiency and effectiveness (1997a, 2002). For Blair and others (e.g. Blair, 1995; Kelly and Parkinson, 1998), stakeholders who make firm specific investments and contributions and bear risks in the corporation should have residual claims and should participate in the corporate decision-makings to enhance corporate efficiency. In Blair's view, in the case of firm-specific investments, "competitive markets are of little use in determining how to allocate the rents and risk associated with those investments" (Blair, 1995, pp. 267). Thus, stakeholding governance is better exercised through internal control mechanisms rather than external markets, such as corporate boards acting as representatives of stakeholders in the corporation. Corporate governance systems and contractual arrangements "should be devised to assign control rights, rewards, and responsibilities to the appropriate stakeholders – the parties that contribute specialised inputs" (Blair, 1995, p. 274).

Managerial trusteeship

The economic approach in conventional corporate governance analysis (such as the shareholding perspective and the instrumental stakeholder theory as indicated above) typically presupposes a taken-for-granted human nature as "self-interested" and therefore concludes that managers as agents cannot be trusted (note that agency relationship is also assumed in stakeholder theory, Hill and Jones (1992), for example, assert a stakeholder-agency theory). However, the assumption of untrustworthy managers is rejected in the

management literature (e.g. Marris, 1964; Nichols, 1969; Etzioni, 1975). As a contrast, it is suggested that managers are good stewards of the corporation and diligently work for the maximisation of corporate profit and shareholder returns. The stewardship theory argues that managers have a wide range of motives beyond self-interest, such as the need for achievement and recognition, the intrinsic satisfaction of good performance and success, respect for authority, the work ethic, and so forth. Thus, managers as stewards are trustworthy and a professional management is beneficial for corporate performance and shareholder wealth (Donaldson and Davis, 1994).

While stewardship theory is mostly consistent with a shareholder perspective (but from a different assumption of human nature), a trusteeship model is proposed by Kay and Silberston (1995) in connection with the stakeholder perspective. They start their argument by describing the current practical state of a publicly held corporation that shareholders do not actually possess the ownership of a corporation and are not interested in running corporate business. Further, they suggest that company law does not explicitly grant shareholders ownership of corporations, since the corporation is an independent legal person with its own ownership separated from its shareholding members and shareholders are merely the "residual claimants" of the corporation (see also Deakin and Slinger, 1997; Warren, 2000, p. 18). Thus, Kay and Silberston reject the idea that directors/managers are agents of shareholders and argue that managers are trustees of the corporation. Tricker (1996) also notes that in company law, behind the idea of directors having a fiduciary duty is a philosophy of directors as trustees. They are principals rather than agents (Dallas, 1988). Sympathising with the assumption made by the earlier organic theory in company law, which is more prevalent in continental Europe, Kay and Silberston (1995) suggest that the corporation is not simply created by private contract, but by the company law, and the corporation is a social institution with a corporate personality which has its own assets and rights and duties, its own will, capacity and responsibilities for its actions. Hence, directors as trustees should not serve the financial interest of shareholders alone, but promote the broader interests of the corporation as a whole. For this reason, statutory change in corporate governance is needed (such as the amendment of company law) to change the current statutory duties of the directors from maximising shareholder interest to pursuing the long-term value of the

whole corporation. Empowering independent directors and fixing CEOs' term of office to a maximum of four years are also necessary for the corporation as a social institution.

Shareholding vs stakeholding: do they map the territory?

The current fierce debate between the shareholding and stakeholding perspectives (for the recent arguments, see Sternberg, 1998, 2000; Vinten, 2001; Turnbull, 1997a, 2002; for a survey of the recent dispute and tendency in the UK, see Gamble and Kelly, 2001) represents two extreme positions and a polarised approach in understanding corporate governance (Prabhaker, 1998; Friedman and Miles, 2002). Underlining the argument are two conflicting and competing ideologies, cultures and value judgements within capitalism. As examined in the last two sections, at one end is the traditional dominant wisdom of "individualism" – private property and individual liberty, and thus the justification of maximising shareholders' value as the sole purpose of the firm. At the other end is the communitarian notion of property and social institutional conception of the firm and the idea of "justice for all", and thus the legitimisation of accommodating all stakeholders' interests by a firm. On the surface the instrumental stakeholder theory seems to bridge the two ends, but in fact it either falls within a shareholder purpose of the firm or claims for stakeholder intrinsic value in forming business strategy. These polarised conceptualisations insist on their own ideologies and paradigms as apparently universally valid and unchangeable, and exclude the possibility of incorporating ideas and assumptions from other or even opposite positions. While both perspectives of shareholding and stakeholding presuppose a fixed notion of social reality as ideal or optimum, reality itself does not have such a fixed nature and property. Nor does it hold some enduring and universal form and principles of governance. Rather, there has been a continuous shift of paradigms and mindsets from shareholding to stakeholding in the Anglo-American setting.

The paradigmatic shift from the shareholder model to the stakeholder model was mostly observable in the late 20th century. The stakeholder model employed in practice can be traced to the 1930s' Depression, when the General Electric Company promoted stakeholders' interests such as shareholders, employees, customers and the general public in order to survive the economic crisis

(Preston and Sapienza, 1990). This stakeholding notion was followed by Robert E. Wood, then CEO of Sears, in the 1950s, who suggested that shareholders' long-run profit could be enhanced by satisfying the needs and expectations of other stakeholders (Hummels, 1998). From the 1960s through to the 1980s, the stakeholder concept was popular among consumerists, environmentalists and social activists. It was also used by corporate executives to defend against takeovers in the 1980s. It was nevertheless in the 1990s that the stakeholding perspective began to be widely used in the corporate governance debate (Blair, 1995). The change of mindsets in practice was first signified by the Delaware Chancery Court at the end of the 1980s. In the case of *Paramount Communications v. Time Inc.* in 1989, the Chancery allowed Time's directors to reject Paramount's takeover offer even though that offer maximised shareholders' financial value. That was a very influential case in which the traditional shareholder model was denied. In the case of *Credit Lyonnais Bank N.V. v. Pathe Communications Corp.* (1991), the Chancery further promoted a stakeholder model on the basis that directors do not owe duties to any single interest group, but to the corporation as a whole and "the community of interests that the corporation represents" (quoted in Sullivan and Conlon, 1997). Since then, the new perspective has been so influential that up to 2000, 25 states of the USA had amended their General Corporation Laws to incorporate the stakeholder concept, while most of the states had expressly permitted directors to take into account the interests of stakeholders in their decision-making (Stoney and Winstanley, 2001; Van der Weide, 1996). In the UK, a similar paradigmatic shift has been experienced since the early 1990s (Dine, 2000). It is not only perceived by judiciaries, academics and politicians, but also by corporate practitioners and managers. A longitudinal study of British managerial mindsets between 1980 and 2000 (Poole *et al.*, 2001) indicates a sharp increase (20 per cent on average) of managerial emphasis on stakeholder interests and a drop (10 per cent) of emphasis on shareholder value in 2000, compared with those in 1990. Most of the managers (nearly 80 per cent on average) attach importance to stakeholders in 2000, compared with only 50 per cent in 1980. In the USA, 75 per cent of managers are now familiar with the term stakeholder (Vinten, 2001).

Arguably, such a paradigmatic shift does not necessarily represent a true dominance of stakeholder forces since the 1980s or a real managerial consideration of intrinsic moral value in business operation as the stakeholder

theorists often claim. For example, in Railtrack, a privatised railway infrastructure company in the UK in the 1990s, stakeholder interests were explicitly emphasised by its management and in its annual reports. But in the firm's decision-making, customer services and safety remained secondary to short-term shareholder value maximisation. Railtrack's Chairman publicly admitted that there was a conflict between profit and safety, between shareholder value and stakeholder interest (for more details, see Wolmar, 2001; Murray, 2001). Evidence also shows that in the UK the real demand of stakeholder groups on caring about corporate reports and performance did not increase, but actually decreased, between the 1970s and the early 1990s (Letza and Smallman, 2001). Large empirical investigations also suggest that corporate social performance does not necessarily result in positive corporate financial performance. In a meta-analysis of 51 studies within 25 years from the 1970s to the 1990s, Griffin and Mahon (1997) find that 33 research results support, while 18 do not support, the correlation between corporate social performance and corporate financial performance. In fact, the massive media coverage largely influenced the socially perceived importance of stakeholders' interests in the 1990s, due to academic and political concerns about the issues of corporate social irresponsibility, short-termism and the negative consequences of the takeover movement in the 1980s (see Berglof, 1997; Gamble and Kelly, 2001). Media, politicians and scholars may represent part of indirect stakeholders and exert influences at a time, but the true forces and powers of direct stakeholders of a firm are still unclear. They are dynamic and fluctuated because they do not merely follow any pure economic principle and rationality such as efficiency, but also are affected by many factors such as politics, ideology, culture, social conventions and modes of thought. Shareholding and stakeholding are socially constructed rather than pre-given and taken-for-granted. Social crisis and political power are two major stimulators for social changes (Fligstein, 1990).

Therefore, it is obvious that as social reality itself (including corporate practices and societal mindsets) is completely flowing and changing, the assumed extremity and thus durability and universality of corporate governance models are less valid and creditable. What is fixed is the artificial conception and the entrenched position of either shareholding or stakeholding, insisted by advocates as pre-given and taken-for-granted. The paradigmatic shift between the shareholding and stakeholding perspectives also implies that historically, even theorising or ideal-

construction itself is transformable and unfixable. At one time, we may give priority to shareholder interest and at other times we may emphasise stakeholder interests due to practical and social reasons or simply, beliefs/faiths. Ideal social conditions are never available in practice, nor capable of being represented in theory as permanent, as once-and-for-ever. Only process and change is absolute. For example, while the dominant shareholder model subscribes to a single optimal form of governance such as internal monitoring or market discipline for efficiency considerations, it is hard to find evidence that either the hierarchical or market form is totally effective. Quite on the contrary, both types of governance structures and mechanisms have failed in practice (e.g. Bishop, 1994; Hart, 1995; Hawley and Williams, 1996; Latham, 1999). As Wolf (1988) points out, we do not have a perfect choice between market and hierarchy; we only have a choice between imperfect markets and imperfect hierarchies as well as imperfect combinations of both. Fligstein and Freeland note that there is no universal governance structure ever found throughout the world and "there is also little evidence that relations between firms are converging toward markets, hierarchies, networks, or strategic alliances as the dominant form of governance" (1995, p. 39). Governance practices reflect the priorities, preoccupations, political inclinations and local conditions of a particular community. Mueller (1995) also argues that governance structure cannot be pre-designed as optimal or "appropriate". It must emerge through a dynamic process in which there are continuous interactions between choices made and their complex contexts. It is hard to find a reliable structural solution to the governance issue, especially when working across cultural boundaries and historical periods.

Recent challenges to the understanding of corporate governance

Very recent studies of the theory of the firm and corporate governance may help in part to understand the static limitations of both shareholding and stakeholding models. Current analysis of corporate governance relies very much on an old conception of the firm, which was characterised as asset intensive and vertically integrated in the late 19th and early 20th centuries (Chandler, 1977, 1990). In company law the modern corporation is defined as an independent and permanent entity with clear-cut boundaries and with direct control over its

employees, suppliers and distribution system. The concept of ownership is traditionally perceived as the ownership of physical assets such as capital and the means of production. Power and authority and residual claims are all based on the source of ownership. Thus, Berle and Means (1932) framed corporate governance as the determination of ownership of the firm and whether the true owners can exercise their rights adequately and effectively (see Zingales, 2000). With this underlying theory of the firm, both the traditional shareholder model and the challenging stakeholder model make their basic assumptions and theorems seemingly justifiable. For example, with the conventional sense of ownership and the firm as a clearly bounded entity, the shareholder perspective enjoys its theorising of corporate governance upon the notions or assumptions of private property, the nexus of contract, self-interest human behaviour, the principal-agent relationship, self-regulation and the optimum of market governance. The stakeholder perspective also legitimises its claims for stakeholder involvement in corporate governance based on the assumption of the firm as a solid and permanent social entity and some universal principles, such as moral value, social justice, mutual trust and/or ownership rights as naturally produced. All those justifications implicitly presuppose that the conventional theory of the firm is as pre-given and unchangeable.

Zingales and others (e.g. Zingales, 2000; Rajan and Zingales, 2000) suggest that the traditional definition of ownership and the firm could be valuable in a society where intensive assets is far more significant for the exploitation of economics of scale and scope, such as that during the industrial revolution. However, business reality is not fixed and "The nature of the firm is changing" (Zingales, 2000, p. 1624). Several important features of corporate change are notable here. Large conglomerates have been broken up into several smaller and independent companies. Vertically integrated manufacturers have changed their direct control over suppliers into looser collaborations. Financing in capital market is much easier and physical assets are easily replaceable and less unique to business development. In the era of the knowledge economy and with the increase of global competition, the demand for process innovation and quality improvement is much higher and therefore the human resource base becomes much more vital to a firm's survival and development. The global markets offer many employment opportunities and make human capital more independent, enabling individuals to build their own business. All these

changes, as Zingales points out, make the boundaries of the firms unfixable and constantly floating.

The change nature of the firm forces us to abandon the illusion that firms' boundaries are clear cut and remain unchanged when we change the capital structure or the governance structure. (Zingales, 2000, p. 1644)

If the firm is not perceived and conceived as a solid and enduring entity and a pre-given and fixed object of study, the consequence would be that the current analysis of corporate governance based on the static conception of the firm and its ownership structure is less convincing and reliable. Indeed, we need to re-define the concept of ownership to include not only physical assets, but also human capital and social capital. In addition to traditional physical assets, a range of resources are becoming increasingly important to today's business, such as creative knowledge, ideas and unique skills, professional control, social relationships and corporate reputation. Financial capital, human capital and social capital are all crucial (but always dynamic and context-dependent) for a corporation. The traditional analysis of corporate governance that relies on a fixed boundary of the corporation (such as the assumptions of a physical *entity*, a natural *entity* or a social *entity* as previously mentioned) is unrealistic. The split of shareholding and stakeholding as universally applicable is not reliable in matching to reality.

While the inadequacy of the shareholder and stakeholder models is easily found from the above analysis, the limits of the stakeholder perspective can be further displayed here. In addition to the earlier critiques of the stakeholder model, such as the stakeholder identity problem (Donaldson, 1989), no clear yardstick for judging corporate performance (Bishop, 1994) and no clear guidance for stakeholding application to managerial practice (Blair, 1995), more fundamental issues remain within the stakeholder paradigm. For example, Friedman and Miles (2002), among others, note that the stakeholder theory presumes a clear-cut, stable and homogeneous boundary among stakeholding groups, between stakeholder legitimacy and illegitimacy, and in managerial perception of stakeholder–corporation relationships. However, in practice stakeholder interests are so diverse and conflicting that not only may it be incompatible between different stakeholder groups, but also within a single group. For example, individual employees or suppliers or even shareholders always have different as well as changeable attitudes toward, interests in and relationships with a particular

corporation over time. Managerial perceptions of stakeholder–corporation relationships, actual power possessed by stakeholders, and stakeholding legitimacy and urgency are totally dynamic (Mitchell *et al.*, 1997). In different organisational life cycle stages, certain stakeholders may be perceived to be more important than others to satisfy critical organisational needs (Jawahar and McLaughlin, 2001). Friedman and Miles (2002) suggest that organisation–stakeholder relations always change, not necessarily materially, but also ideologically, and their relations may change in any direction. The triggers of such a change could be from institutional support changes, contingent factors emerging, sets of ideas held and changed by stakeholders and organisations, and material interests changed from stakeholders and organisations. They argue that “the weakness of stakeholder theory lies in the underspecification of the organisation/stakeholder relation itself” (Friedman and Miles, 2002, p. 15).

Some concluding remarks

Current mainstream schools of corporate governance rest their ideas and assumptions on a theory of the firm and associated ideologies which were created and constructed by company law theory and classical economics in the 18th and 19th centuries. Under this conventional wisdom, physical assets are perceived to be more important than human resources. Corporate power and authority is legitimately built on the exclusive possession of financial capital, raw materials and the means of production. Free market exchange and vertically integrated bureaucracy are justified as ideal and universal principles for efficiency reasons. The corporation is regarded as a solid and enduring entity or the aggregation of individual entities, with a clear division between inside and outside, the corporation and its environment, and with a fixable identity of shareholders and stakeholders. These ideal-constructions, as argued above, might have been acceptable in earlier times and under certain conditions and contexts. If we accept that our society and environments are continually fluxing with an uncertain future, we must critically scrutinise whether or not the conventional wisdom and assumptions are still compatible with current situations of corporate practice and societal development (including social expectations). The split between shareholding and stakeholding in current theorising of corporate governance is less valuable, since both material conditions and ideological perceptions have changed sig-

nificantly in recent times making the polarisation of shareholding and stakeholding now somewhat redundant.

In order to make their theories universally justifiable, both the shareholding and stakeholding perspectives attempt to generalise and simplify their theories, even though corporate governance practice is very dynamic and complex. For example, the universal principal-agent relationship, self-interested human behaviour, the inherent individual property rights and the uninterrupted self-regulation mechanism underpinning the shareholder model and the pre-given moral value, trusteeship and other social principles and the single and simple identity of stakeholder groups underpinning the stakeholder model. All those assumptions and presuppositions tend to abstract and fix reality and ignore or neglect the flux and heterogeneity of corporate governance in practice. In so doing, however, the advocates seem rather puzzled about the lack of evidence in support of their theoretical models.

The most popular approach in corporate governance research is economic analysis. This is manifested in both the shareholder model and stakeholder model. Underpinning both models is the continuous search for the optimal governance structure which purportedly lies in the most efficient form. Further, the models claim that there exists a rational process of selecting more efficient governance structures and mechanisms either through the "invisible" hand of the market or the "visible" hand of managers or stakeholders (see Solomon and Higgins, 1996; Roy, 1997). Although the shareholder and stakeholder perspectives are different, common to both models are the notions of profit maximisation, an increasing market value and economic rationality and efficiency. The economic rationale employed in the governance debate ignores the basic fact that corporate governance is a social process, which cannot be isolated from social and other non-economic conditions and factors such as power, legislation, social relationships and institutional contexts (Roy, 1997). Theories grounded on economic rationality tend to neglect or marginalise the importance of irrationality, emotion, value, belief and ideology, which often play a significant role in the process of decision-making and governance (see, for example, Welcomer *et al.*, 2000; Jawahar and McLaughlin, 2001). Consequently, the limitations of the economic approach are obvious, as Grundfest posits:

There is no reason to believe that corporate agency problems can be resolved in an econom-

ically rational manner, or that the corporate governance process will, over time, tend toward greater economic efficiency. (Grundfest, 1990, quoted in Hawley and Williams, 1996, part II)

Indeed, corporate governance is not science, but an art,⁴ as William Allen (2001), the former Chancellor of Delaware Chancery Court in the US, suggests. For Allen, good corporate governance may have good effects on long-term corporate financial performance. But the definition of good standards of governance cannot be measured by scientific precision. "Corporate governance functions only through human action, which itself is affected by a high number of changing, interacting variables" (Allen, 2001, p. 2). Any single model and structure of corporate governance cannot work well for all firms at all times. Corporate governance needs to be flexible, adaptable and innovative. Therefore, for theoretical models to be workable and explicable in practice, we need to develop approaches and models which better explain the idiosyncratic workings of local corporate governance, rather than try to force-fit reality into the established abstracted templates. We need a new mode of thinking in the analysis of corporate governance, which goes beyond the conventional static approaches. A new mode of thinking that would explain some important phenomena in corporate governance, contrary to the conventional theoretical assumptions. For example:

Whereas the shareholder perspective regards the corporation as the extension of individual private property and a nexus of free exchange, corporate legal relationships show that the corporation is actually an independent organisation with its own rights and liabilities separate from its members/shareholders. The traditional rationale of private ownership has been transformed. The process of incorporation (for both public and private companies) can no longer be viewed as a purely private ownership matter in the traditional sense. Shareholders do not have individual free rights and claims on the corporation. They bear only very limited liability and risk. The entire liability and risk of the corporation are shared by many stakeholders including shareholders, bondholders, creditors, employees, suppliers, the government and the public at large. In this sense, all companies have some public character. The nature of incorporation cannot be explained by the current shareholder perspective based on a purely economic and financial analysis that totally ignores corporate legal relationships.

Whilst the stakeholder perspective might justify its rationale based on the 19th century's conception of social entity or natural entity, it neglects to acknowledge that companies are not the same as other social institutions. As business operators, companies are duty-bound with economic and profit-making functions for society's survival and development. Furthermore, there has long been an argument in corporation law theory about whether or not the corporation, as a legal person, is a real person or an artificial person (Mayson *et al.*, 1994). The current stakeholder model regards the corporation as a discrete social entity and is compatible with the "real personality" assertion. This logically supposes that the corporation is a real person, independent of its members, and draws the image of an empty entity where all stakeholders are external to and influential on the corporation. This simply ignores the actual process of incorporation, where the corporation is a constituent of its members. Without its members, no corporation can exist in law (throughout the world, a corporation must have at least one member). In company law, the corporation is seen as a complex rather than a simple phenomenon where it is seen as both the association of its members and a legal person separate from its members. A simple stakeholding model ignores this complexity.

Both the shareholding and stakeholding perspectives present the corporation in terms of "entity" (either individual entity or social entity). However, the corporation as a social and legal product is not so entitative and solid in practice over time. For example, Zingales (2000) realises that whereas in physical-asset-intensive firms their boundaries might be stable and corporate governance could rely on "shareholder ownership" (note that this assumption is also problematic in company law theory as mentioned above), in human-capital-intensive firms their boundaries become diffused and governance under the traditional approach becomes more problematic. Indeed, neo-classical economics regards the firm as a legal fiction, a nexus of contracts. But in so doing economists do not question the notion of individualistic entity behind their assumptions such as a fixed shareholder ownership, permanent interest and group homogeneity. They talk about agency problem in corporate governance, but neglect the principle problem, such as shareholders being reluctant, less interested, legally restrained or mutually conflicting in monitoring agents' performance. It is those dynamic practices that challenge the assumed boundary and fixed entity of a corporation.

While both shareholder and stakeholder models suggest either a hierarchical form of

governance or market governance as an optimal governance mechanism, in practice governing forms may vary. Hollingsworth and Lindberg (1985), for example, identify four distinctive forms of governance, including hierarchies, market, the clan or community and associations. Whilst economists only recognise the former two forms, the latter two forms may offer more value in corporate governance in non-Anglo cultures, such as in Asian countries (Tricker, 1990; Porta *et al.*, 1997). Even within the Anglo-American environment, network forms of governance based on mutual trust, friendships, reputation, shared ideology and reciprocity have also attracted attention in business practices since the 1980s (Powell, 1990). Thus, Turnbull (1997) suggests that economists such as Coase (1937) and Williamson (1975, 1985) ask the wrong question, why are economic transactions organised through hierarchy rather than through markets? They "should have asked *when* are economic transaction organised by any *combination* of the four different ways (as mentioned above) in which transactions can be governed" (Turnbull, 1997b, p. 186, emphasis added).

Both shareholder and stakeholder perspectives claim superiority of their models respectively; however, in reality we have seen a dynamic shift with both models becoming increasingly mutually attractive all over the world in the last two decades. This paradigmatic shift has been a major theme in this paper. For example, evidence shows that even Germany and Japan, which traditionally preferred a stakeholder-committed model, have recently changed towards a more shareholder-valued and market-based model due to the pressure of globalisation and world-wide competition (Stoney and Winstanley, 2001, p. 618; Schilling, 2001). All this implies that the so-called superiority and priority of any model is not permanent and universal, but rather temporary and contextual. The static conceptualisation of shareholding and stakeholding is less compatible with the fluidity and diversity of practical reality.

The current dichotomised and static theoretical approach used in corporate governance research, which presupposes two extreme and opposite ideal models, cannot fully explain the complexity and heterogeneity of corporate reality. Instead, we call for a more inventive and flexible approach to the understanding of corporate governance practice and the search for effective and efficient governance. What would be involved with such an approach?

It is a processual, rather than a static approach. This approach explains the temporary, transient and emergent patterns of cor-

porate governance on a historical and contextual interface in any society. Corporate governance is completely changeable and transformable and there is no permanent or universal principle which covers all societies, cultures and business situations. It acknowledges that corporate governance models around the world have developed from their own unique cultural, historical and social circumstances. It also acknowledges that each model will continue to evolve. For example, actors in the Anglo-American and the German-Japanese governance environments will learn from each other, each taking aspects of the other's model, in order to compete more effectively in a globalised market in an era where information is increasingly becoming more freely available. Learning is a continuous process; it never stops and has no end.

It is a balanced approach which never assumes that any extreme model, such as pure shareholding or pure stakeholding, can work perfectly in practice. A firm is neither a purely private nor a purely public affair. A firm does not just consist of physical assets, but also of human beings, and shareholders and other stakeholders. In today's civilised society, human beings should not be treated as assets, machines or any form of instrument (e.g. Handy, 1993). Also, governance forms should not be polarised into either "hierarchy" or "market". Other forms of governance, such as networks, may have much value.

It is a relational approach which views the reality as fundamentally interconnected and interdependent and mutually influential. In order to learn business relationships must think about corporate interrelationships and social interactions. Thus, shareholder interest is not independent of stakeholder interests and vice versa. A firm is not independent of its constituents. Any externalised views that separate and isolate the corporation and its stakeholders, or shareholders and stakeholder, indeed over-simplify and make the social reality artificial. Dichotomy approaches or binary values are less applicable to the complex real world. A "fuzzy logic" is more valuable in understanding corporate relationships.

It is a pluralist approach which suggests that corporate governance is not only conditioned to the economic logic such as economic rationality and efficiency, but also shaped and influenced by politics, ideologies, philosophies, legal systems, social conventions, cultures, modes of thought, methodologies, etc. A purely economic and financial analysis of corporate governance is too narrow. We have already seen some research in this field based on politics, culture, power and cybernetics (for

a useful review, see Turnbull, 1997b), which may offer insightful views from different angles and quite distinct from the mainstream analysis.

It is a dynamic and flexible approach which continually weighs and adjusts the method of governing in practice. It cannot design and specify any ideal model in advance and cannot be fixed as a "once-and-for-ever" solution. It is a principle of *collibration*, that is, the design and management of institutions through explicitly juxtaposing rival viewpoints in a constant process of dynamic tension with no pre-set equilibrium (Hood and Jones, 1996).

It is an enlightening approach that attempts to transcend our habitual, inertial, static and stagnant ways of thinking about corporate governance. As Morgan (1997) notes, people are easily trapped by favoured ways of thinking that serve specific sets of interests and consequently our conventional modes of thought may in turn bind and control our views. We need to think outside of the current polarised models framework. We need to understand deeply what corporate reality is, how and why we have constructed it both collectively in history and in different contexts, and what trends and patterns could be most likely to emerge in the uncertain future. Certainly, we need more radical research in this area.

Notes

1. There are two disputes in the literature on whether or not the German and Japanese governance style is a stakeholding model and whether or not their governance model is more advantageous in international competition. It seems that many scholars tend to recognise that there are two different governance styles of capitalism, one is the Anglo-American style and the other is the continental European-Asian style. While the former tends to adopt a shareholder interest maximisation and market governance, the latter is less shareholder-focused and more stakeholder-oriented and does not rely primarily on stock market control over the large corporations. Some scholars also argue that whilst the Anglo-American style dominates the world, the German-Japanese model appeared to be more efficient, more equitable and more successful in the 1980s (for more details, see Albert, 1993; Charkham, 1994; Kay and Silberston, 1995; Hirst, 1998; Weimer and Pape, 1999).
2. A Joint-Stock Companies Act was passed by Parliament in 1844 and an Act for limiting the liability of a corporation's members passed in 1855. Both legislations laid down the foundation of modern corporations. For more details, see Tricker (2000).
3. In corporate law theory, members of a corporation refer to its shareholders. But in the 19th

century there was a German view of the corporation, which regarded the employees, rather than the shareholders, as the members of a corporation (Pejovich, 1990).

4. However, some scholars suggest the opposite, that corporate governance is a science, not an art. Turnbull (2002) argues that corporate governance could be grounded in the science of information and control (i.e. cybernetics) and thus a compound board has a cybernetic advantage over the unitary board. We do accept that information is an important issue in corporate governance; however, we doubt the assumption underpinning the science of governance that information is the main issue of governance and information itself is a natural phenomenon. In fact, the information problem is far beyond an issue of human ability of dealing with information overload or natural bias and errors. There are a variety of social, cultural, legal, political and psychological factors influencing and distorting the process of information. Furthermore, human beings are unlike computers that can be precisely and relatively easily controlled.

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“[Having a non-executive chair is] about having somebody to take a lot of responsibility for the governance of the company and information flow and discussion flow. It’s a decision based on improved governance.” *Michael Eisner*, In “*Corporate Governance Alliance Digest*”, March 2004, www.corporategovernancealliance.com

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