JOURNAL OF INTELLECTUAL PROPERTY AND HUMAN RIGHTS

Volume: 4 Issue: 2 | Feb–2025 ISSN: 2720-6882
http://journals.academiczone.net/index.php/jiphr

From Shareholders to Stakeholders: Shifting Paradigms in Corporate Leadership

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Annotation: This article explores the contentious debate regarding the fiduciary duties of company directors, specifically examining whom directors should prioritize in their corporate governance—shareholders or stakeholders. This discussion is critical as the role of the corporation in society evolves and as various interests increasingly intersect. Historically, the shareholder primacy theory has dominated Anglo-American corporate law, advocating that directors' primary responsibility is to maximize shareholder value. However, this perspective has faced growing criticism for failing to consider the broader impacts of corporate decisions on non-shareholder stakeholders such as employees, customers, suppliers, and the community at large.

Key words: Corporate Governance, Shareholder Primacy, Stakeholder Theory, Fiduciary Duties, Corporate Responsibility.

Introduction

1-In whose interest directors should run the company?

One of the arguable questions which have been discussed among corporate scholars and lawmakers is for whom company should be run or how directors hold the balance of different stakeholders' interest. This phenomenon has been discussed for more than one century. However, it does not find its proper solution. Some scholars[1] have argued that company is a private institution and therefore it should serve only for the interest of its owners, while others[2] contrasted that, a company is more than a vehicle of making money and has a great economic and social impact to the society. That is why it should serves for the interest of other stakeholders. So there has been a great debate among scholars to identify in whose interest company should be promoted. This chapter discusses different arguments

Method

This chapter analyzes different theories aimed at determining whose interest directors should run the company.

1.1.Shareholders value maximization theory

"All powers granted to a corporation or to the management of a corporation, or to any group within the corporation... [are] at all times exercisable only for the ratable benefit of all the shareholders as their interest appears."[3] *A.A. Berle.*

Shareholder primacy theory has been a dominant theory in Anglo-American corporate law system. This theory has been played a core objective of the economy in most developed countries (e.g. UK and

[1] *M. Friedman, 'The Social Responsibility of Business is to increase its Profits',(1970) N .Y. TIMES MAG, 32-33, A.Berle 'Corporate Powers as Powers in Trust (1931) 44 Harvard Law Review, 1049-1074*
[2] *E. Dodd, "For whom are Corporate Managers Trustees?" (1932) 45 Harvard Law Review, 1145-1163, L. Lan and L. Heracleous , 'Rethinking agency theory: The view from law'. (2010) Vol.35, No2, The Academy of Management Review, 294-314*
[3] *A. Berle, 'Corporate Powers as Powers in Trust, (1931) 44 Harvard Law Review 1049*

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U.S.). According to this theory company should serve only to the interest of its shareholders.[4] To support this argument some scholars state that shareholders are believed owners and residual claimants of the company.[5] However others believe that this argument is outdated and no longer suitable for the objective of modern company law.[6]

1.1.1.Arguments in favor shareholders primacy.

A. Shareholder ownership argument for shareholder primacy.

Most scholars who support the shareholder primacy see the shareholders as the owners of company's assets.[7] It is believed that the assets of the company have been formed by the investment of shareholders who claim the ownership of the company. As owners they want to have a control over the company. The main argument is that if shareholders are believed as owners they should have a right to control it.[8] However, shareholders lack control over the corporation because owing a share of stocks does not mean that they have a control over the company as the control of company belongs to directors. However, the theory sees directors as agents who should serve loyally to the interest of their principals.[9] However, shareholders might be seen as owners of the company, while in courts` view the real owner of the company's assets is company's itself.[10] This decision has been in practice since the case of Salomon v Salomon and Co Ltd[11]. This case has shown that a company should be seen as a separate legal entity which has own rights and responsibilities. Additionally, even shareholders have the rights to remove the directors and using veto rights in some important decisions, it is up to the directors` discretion to decide in the favor of shareholders or other stakeholders.[12] However, shareholder primacy supporters urge that the aim of the company should be to maximize shareholder wealth by giving them ultimate control over the company.[13] Directors should decide any decision for the benefit of shareholders even if it prejudices other stakeholders' interests. For instance, managers may be forced to declare high amount of dividend by firing some employees or closing down of a factory. This phenomenon is in practice even during the global pandemic. According to the Washington Post, during the peak period of pandemic five U.S's big companies paid $ 700 million to their shareholders at the expense of cutting jobs and closing some factories.[14] It seems that directors have not learned from the bad consequences of shareholder primacy during the economic collapses.[15]

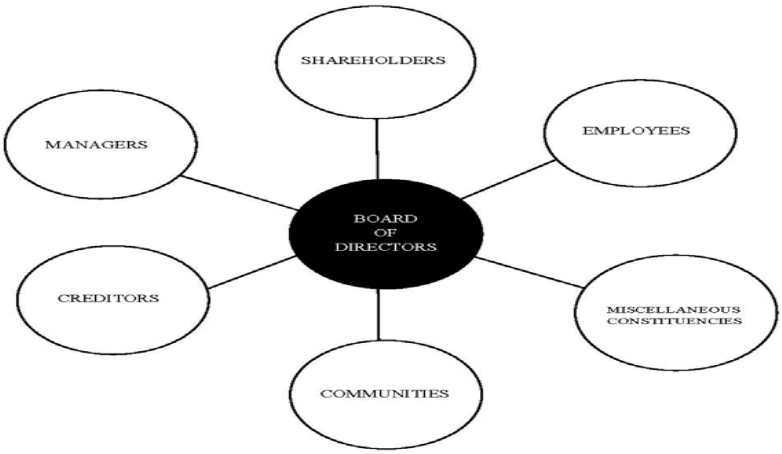
However, according to contractarian theory, corporation is not a thing capable of being owned rather it is a nexus of contract among the various stakeholders. This theory sees shareholders as one of the participants of different groups. Every participant makes a investment in different forms. For instance, shareholders with their money, employees with their special knowledge and valuable time, at the end they expect to return their investment in a form of dividend or fixed wages.[16] According to Bainbridge,

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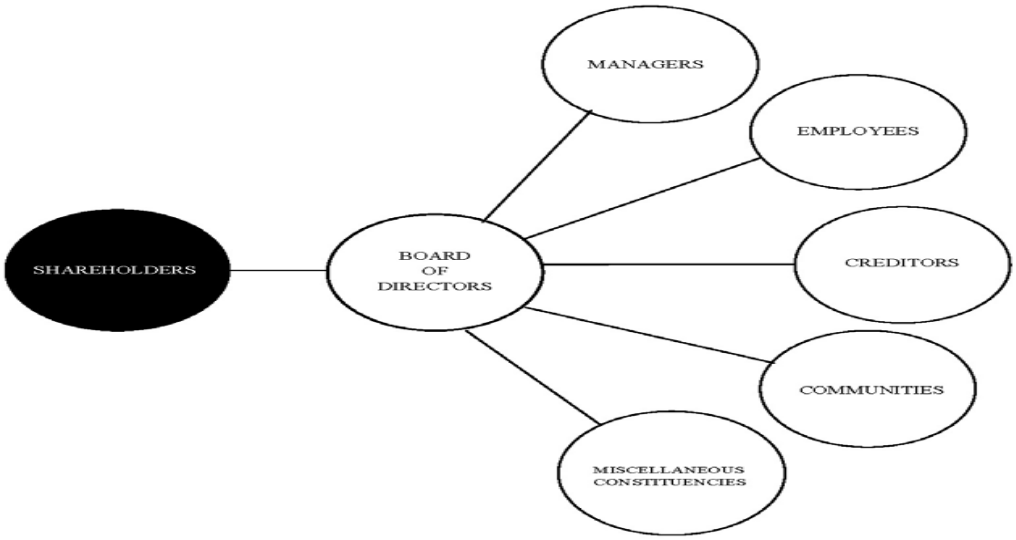
[4] *Berle (n 1) 1049.*
[5] *Frank Easterbrook, Daniel Fischel,'The economic structure of corporate law' (1991) Harvard University Press 36-39*
[6] *A. Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75(5), Southern California Law Review,1195*
[7] *P.Selznik, 'Institutionalism : old and new" (1996) 41 Administrative Science Quarterly, 271*
[8] *J. Velasco, 'Shareholder Ownership and Primacy' (2010) No.3, University of Illinois law Review 908*
[9] *Dodge v. Ford Motor Co [1919] 204 Mich. 459.*
[10] *Short v Treasury Commissioners [1948] 1 K.B. 116*
[11] *[1897] AC 22, (House of Lords).*
[12] *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame [1906] 2 Ch 34.*
[13] *S. Bainbridge 'Director Primacy : The Means and Ends of Corporate Governance' (2003) Northwestern University Law Review 573*
[14] *Peter Whoriskey, 'U.S. companies cut thousands of workers while continuing to reward shareholders during pandemic' (The Washington Post, May 5 2020) https://www.washingtonpost.com/business/2020/05/05/dividends-layoffs-coronavirus accessed 11 August 2021*
[15] *'Enron's Corporate Culture and Ethics Failure' 2020 https://studycorgi.com/enrons-corporate-culture-and-ethics-failure accessed 21 August 2021*
[16] *Frank Easterbrook, Daniel Fischel,The economic structure of corporate law (1991) Harvard University Press 4-8*

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corporation is a nexus of contract and at the center of this nexus stays board of directors whose work is to manage corporation by interacting with other groups including shareholders.[17]



However, Velasco states that describing the company as nexus of contract is entirely inadequate. He opines that shareholders have priority over other stakeholders, given that they own the company and have a right to elect or remove directors. Therefor board of directors has fiduciary duties to manage company in the interest of shareholders. He describes the board as a bridge between shareholders and other stakeholders.[18]



As the author's view, although shareholders have the right to appoint or remove directors from the board; it does not mean that they own the company. In fact they own the stocks of the company but not the company itself.[19] Additionally their right to appoint or remove directors is relatively weak as one shareholder cannot use this right while collective action requires much effort and time. As an alternative they may sell their shares to outsiders which make company much vulnerable to fight

[17] *Bainbridge (n 12) 554–60, diagram at 560 fig.3*
[18] *Velasco (n 7) 923*
[19] *F. Fama 'Agency Problems and the Theory of the Firm' (1980) Vol.88, No.2, Journal of Political Economy, 290*

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against hostile takeovers. In order to make company more stable managers need to satisfy the wishes of shareholders and provide the minimal amount of profit for them.[20]

B) The residual claimant argument for shareholder primacy.

The classic example of regarding shareholders as the residual claimants can be found in the work of Frank Easterbrook and Daniel Fischel.[21] According to their views as mentioned earlier company can be seen as a nexus of contracts among shareholders and other stakeholders. Unlike shareholders, other groups like employees, managers and creditors have explicit contracts which allow them to get fixed payments, such as salaries and interest rates. However, shareholders are not bound with explicit contract with the company. They have implicit contract which entitles them to get a benefit after satisfying the explicit obligations of stakeholders. That is why shareholders can be seen as the sole residual claimants of the company.

Another explanation was given by Julian Velasco who argued that shareholders as the sole residual claimants because they are entitled to get profit after the company has met its obligations in front of stakeholders. No stakeholder meets this definition except shareholders.[22] Unlike other stakeholders, who profit or lose only fixed wages but nothing more than upon their explicit contracts, the shareholders bear all the risk directly.

However, some scholars contrasted to the opinions of Frank Easterbrook and Daniel Fischel and argued that residual claimant argument for shareholder primacy is a *"naked assertion"* and does not match with the rules modern corporate law.[23] First, it is not accurate to describe shareholders as the sole residential claimants, because like shareholders other stakeholders as well make special investment to the firm. For instance, employees might invest specific human capital, suppliers might provide special equipment, and customers might prove their trust and loyalty by being patient to the company. However, when bad times come to the company not only shareholders but also all the stakeholders suffer severe loss.[24] For instance, employees will lose their jobs besides their time, creditors cannot get fixed rate of interest, and customers will suffer from high prices.

Second, shareholders cannot compel the directors to declare a dividend. It is up to the directors` discretion whether they declare a dividend or transfer the company's profit to social welfare like raising employees' wages or improving customers' services. A notable example of directors' independence can be seen in the case of Paramount Communications, Inc. v.Time[25]. This case has shown that how directors are free to decide for the interest of the firm rather than its shareholders. In another word company law allows directors to reduce the value of shareholder interest if it increases the long term success of the company. However, shareholder wealth is not dependent to dividend. Even directors announce to relocate the earnings to the company's long term success rather than declaring dividend it will beneficial for shareholders too.[26]

1.2.Stakeholder theory and relationship between beneficiaries and trustees.

"Corporations are economic institutions that have a social service role to play as well as making profits for shareholders and that companies have responsibilities to the company's shareholders, employees, customers and general public"[27] *E. M. Dodd*

[20] *Alan Dignam and Jon Lowry, Company Law, (11the edn, Oxford University Press, 2020) 405*
[21] *Easterbrook (n 14) 36-39*
[22] *Velasco (n 7) p 913*
[23] *Stout (n 5) 1193*
[24] *Ibid 1194*
[25] *[1989] 571 A.2d 1140*
[26] *Velasco (n 7) 913*
[27] *Dodd (n 3) 1145*

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According to the stakeholder theorists, shareholders' are not regarded only residual risk owners of the company. There are other participants like employees, suppliers, creditors who may bear significant risk through the company's decisions. [28] In other word every decision of the Board of Directors effects to the rights of these constituencies. For instance, if the Board of Directors decides to increase the amount of dividend, it will be achieved by reducing the amount of employees' wages or closing down some plants of the company. As a consequence, employees may lose their job positions, customers may be affected by high prices, and creditors might be affected by financial procedures. If a company neglects the stakeholders' interests by mistreating its employees, making ineffective communication with their consumers or damaging to the environment, it cannot go to further destinations. Dissatisfied employees may express their sadness by going on strike, consumers may boycott the products of the company and suppliers might find another friendly partners for their products. Some scholars argued that shareholder oriented system leads such kind of economic downfalls as it demands only maximization shareholders' value by making short-term profits.[29] Enron's fall could be an example of failing the shareholder orientated system. It is an illustration of inefficient mechanism of shareholder value maximization which leads to manipulate economy in order to get high share price even the company faces with financial difficulties. One of the conclusions from Enron's failure is that when the companies face financial difficulties it is not only shareholders, who bear the residual risks but also stakeholders may experience with severe loses. For instance, as the result of Enron bankruptcy more than 20000 employees lost their job as well pensions because they invested over 50 percent their savings to purchase company's shares.[30] As a consequence, the losses of employees have severe impact on society because they are one part of the society. The conclusion is that the aim of business should not be making profit for its owners rather it should serve to the interest of community.[31]

Result and discussion

According to the stakeholder theory, all participants who have stakes in the company should work together under the common goal to make profit for all.[32] In other word company should be managed in a way to make benefit for all stakeholders and directors should be accountable to all of them. The main job of directors should be holding the balance among various participants who might affect or be affected by the decisions of the company.[33] As Edward Freeman mentioned in his seminal book stakeholders should have a right to be regarded as an end, and not a means to an end [34] (their interest should not be used as an instrument for the benefit of shareholders, but should be the primary purpose of the company). He opines that first directors should determine certain stakeholders groups of the company and their perceived interests before making any decision.[35] If directors make unfair decision against the interest of stakeholders then they might withdraw their investment from the company. For instance, employees might not work with their full capacity or suppliers might not produce low priced and competitive products, etc. In order to lead the company to success all the stakeholders should be travel in the same direction otherwise they will exit from the company.[36] When the interest of the

[28] *S.Kiarie 'At crossroads: shareholder value, stakeholder value and enlightened shareholder value: Which road should the United Kingdom take?' (2006) International Company and Commercial Law Review 333*
[29] *Ibid 335*
[30] *'Enron's Corporate Culture and Ethics Failure' 2020 https://studycorgi.com/enrons-corporate-culture-and-ethics-failure accessed 21 August 2021*
[31] *Dodd see (n 3) 1149*
[32] *Janice Dean, Directing Public Companies, (2001 Cavendish publishing limited) 94*
[33] *A. Keay, 'Stakeholder Theory in Corporate Law: Has it Got What it Takes' (2010) 9(3) Richmond Journal of Global Law and Business 257*
[34] *E. Freeman, 'Strategic management: A stakeholder approach 25 (1984). Page 97*
[35] *Ibid 53*
[36] *E. Freeman, 'Stakeholder Theory and the Corporate Objective Revisited' (2004) Vol. 15, No.3 Org. Sci. 365*

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stakeholder is treated fairly, they will continue to invest in the company. Employees work harder and serve loyally even in financial difficulties, creditors may agree to lower interest, etc.[37]

However some critics of stakeholder theory argue that this theory is not unworkable because it is deeply dangerous and harms private property rules, rejects the agent's duties to principals.[38]

1.2.1. The problems of balancing

As mentioned above some critics of stakeholder theory argue that the main objective of the theory is unworkable.[39] There are different reasons which make the theory unworkable. First, there is not a clear guidance for directors how to hold a fair balance among various stakeholders' interest. Furthermore, the theory does not permit to prioritize the interest of one stakeholder over others. However in practice it is impossible to satisfy all members equally in one time.[40]

Second, the definition of benefit may be different among stakeholders. Even members of one group have different views of profit. Imagine the creditors. They are generally treated as one group who has the same goal and benefit. However, this group is divided to many subgroups whose interest may be different from one to other. For example, secured and unsecured creditors, general trade creditors, suppliers under the long term contracts, customers who have paid for the goods and other. There is a great difference between the interests of banks who lend millions of pounds and self-employed trade persons whose profit merely small amount.[41] Moreover, an individual can be a member of different stakeholder in one time. For example, an employee can be a shareholder or a consumer of the company. So in such situations it is impossible for directors to hold the balance among all stakeholders.

Third, no clear guidance of balancing and responsibility rules leads the directors to make opportunistic actions which mean that directors may take the benefit of company at the expense of others. They can make any decision they want by asserting to hold the balance among the stakeholders. For example they may resist a friendly takeover which is good for the company by assuring that decision has been made for the benefit of employees, creditors and suppliers. Thus they may choose 'quiet life' rather than involving conflict with key stakeholders.[42]

1.2.2. The role of directors in the stakeholder theory.

As mentioned above in stakeholder theory all constituents contribute some part of the investment to the company and work together to make profit for all participants. As a result they expect to get fair portion of surplus of the company. However, it is not easy even impossible to create a balanced decision where all stakeholders enjoy with their stake in the corporation. Arguably the interest of the stakeholders is differentiated among various groups.[43] So there is one reasonable question is that what is the role of directors in this complex relationship and how they hold the balance among different stakeholders?

Some scholars[44] argue that directors should treat equally all stakeholders without prioritizing one over another. Inequality would be permitted only the situation where the action causes for the benefit of all members' interest. However, directors cannot satisfy all participants equally; they should assess and

[37] *Min Yan 'Why not stakeholder theory? (2013), 34(5), Comp. Law 149*
[38] *E. Sternberg, 'The defects of shareholder value (1997) 5(1) Corporate Governance 8*
[39] *Ibid*
[40] *M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2001) 7 European Financial Management 297*
[41] *Keay (note 31) 278*
[42] *M. Blair, A. Stout 'A Team Production Theory of Corporate Law' (1999) Vol. 85, No. 2, Virginia Law Review 306*
[43] *Keay (note 31) 278*
[44] *E. Freeman 'The Politics of Stakeholder Theory : Some Future Directions' (1994) 4 Business Ethics Quarterly 415*

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weight all stakeholders' contribution to the company in order to avoid one sided decision.[45] This task is quite impossible because there are several stakeholders who want to get profit from the income of the company. The first work in front of directors is identifying possible stakeholders of the company. Some scholars divided stakeholders to 'primary' and 'secondary' groups according to their importance to the company.[46] According to their views primary stakeholders are those without whom company cannot run its day to day business. They are employees, customers, shareholders and suppliers. Secondary stakeholders are those who affect or be affected by the decisions of company only in some situations. They are community, environment and government. Where there is a conflict between primary and secondary stakeholders directors should first take account the interest of primary stakeholders. However, it does not mean that directors always discriminate the interest of secondary stakeholders. Even sometime the influence of secondary stakeholders would be much costly to the company. One of the clear examples can be seen from the Shell experience on its big oil storage.[47] So directors should be very careful to accept any decisions by assessing its upcoming impacts to the company.

Stakeholder theory puts much pressure to directors in decision making process because every stakeholder has different demands and spontaneously they want to enjoy from the corporation's surplus. Usually there are different conflicts of interest between several groups. Board of directors is seen as a mediating hierarchy whose job is coming to final outcome by assessing the urgency and legitimacy of each stakeholder's demand. For instance shareholders want to take dividend while employees want to get fixed wages. So there is one question is that whose interest should be satisfied in the first line? Does it shareholders or employees? In this situation stakeholder theory requires directors to make decision for the long term success of the company.[48]

Some scholars argued that corporation is not a bundle of assets of its owners rather it is a team of people who make an agreement to make profit under one umbrella which is called company.[49] They suggest that directors should be under control of neither shareholders nor stakeholders. All participants enter into a *'pactum subjectionis'* which is a mutual agreement among team members.[50] The main purpose of this agreement is giving control to outsiders who have not a direct stake in the firm. Thus in team production theory board of directors is not seen as agents whose job to pursue the shareholders' interest at the expense of other stakeholders. Rather they are believed as trustees of the company whose job is balancing the interest of all stakeholders in order to keep the team happy together. However it does not mean that all the stakeholder take equal and fair profit from the company. They should be rewarded with some portion of surplus according to their importance of contribution.

However some scholars believe that directors might be regarded as one of the stakeholders in the company[51] because on one side they are employees and on other side they might be regarded as shareholders of the company. However, this argument does not fit with the rules of stakeholder theory. It is believed that the main job of directors is to play the role of mediator among the interest of different stakeholders. If they are considered as a stakeholder then how do they play the role of judge? It is possible they may use their position for their own interest rather than stakeholders.

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[45] *R. Phillips, E. Freeman and A. Wicks, 'What Stakeholder Theory Is Not', (2003) 13(4) Bus. Ethics Quarterly 488*
[46] *Dean (note 30) 103*
[47] *C. Zyglidopoulos 'The Social and Environmental Responsibilities of Multinationals: Evidence from the Brent Spar Case' (2002) Vol. 36, No. ½, Journal of Business Ethics 141-151*
[48] *Dean (note 30) 107*
[49] *Blair (note 40) 278*
[50] *Ibid*
[51] *P. Coelho, J. McClure and J. Spry, 'The Social Responsibility of Management : A Reprise' (2003) 18 Mid-American Journal of Business 53*

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1.2.3. Enforcement of stakeholders' remedies**.**

Under the current law there is not any enforcement mechanism for stakeholders to hold the directors accountable. It means that stakeholders have not any tooth to compel directors for their interest. Company law permits only shareholders to sue directors when they breach their duties.[52] However, it does not mean that shareholders have priority right than other stakeholders. Simply they have good position to represent the interest of all the member of the coalition. Company law only permits shareholders to bring an action where an unbalanced decision harmed the interest of all the stakeholders. Moreover, shareholders cannot sue directors when directors make a decision for nonmonetary benefits to themselves at the expense of shareholders. Some scholars labeled this benefit as corporate actions with mixed motives where directors can use corporate funds to build big offices or spend their favorite charities. [53] Although some cases have indicated that shareholder primacy still has a power to enforce directors for the interest of the shareholders[54], most recent cases have proved that even existing case law promotes directors to make decisions more broadly for the benefit of other stakeholders.[55]

However, some scholars urged that it is unfair to give priority to shareholders to enforce directors' duties where the other stakeholders have similar opportunity to protect corporate interest.[56] Employees, creditors, suppliers even environment should have access to the court to protect the company from the wrongdoers. Mostly they have a better position to identify a breach of duties of directors. Take the example of employees (whistleblowers) who are more aware of directors' illegal action or unsecured creditors who are more vulnerable in the process of corporate insolvency. So there should be some enforcement mechanisms to increase the accountability of directors to stakeholders.

Conclusion One of the possible remedy for enforcement issue is giving the right to stakeholders to bring a derivative action against directors.[57] Similar to the existing derivative framework this action could only succeed where it brought on the behalf of the company. Another enforcement mechanism requires creating a new director's duty which is called 'duty not to harm'.[58] According to this duty each stakeholder might be entitled to give a petition to the court where the business of company has been conducted unfairly against the interest of applicants. However, introducing such remedies might have negative effects to the business of the company. First, it limits the freedom of directors to make independent judgment because directors will be more vulnerable in decision making process by hesitating whose interest should be taken. Second, it allows to the courts to intervene the management of the company since courts has been reluctant to do this.[59] Consequently, it slows down the business of the company because of too much intervene and hesitation. On the contrary, giving such rights to the stakeholders would increase the vigilance of the directors to the interest of the stakeholders.[60]

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[52] *UK Companies Act 2006 s 260.*
[53] *Blair (note 40) 299*
[54] *Dodge v. Ford Motor Co [1919] 204 Mich. 459, Revlon, Inc. v. MacAndrews & Forbes Holdings, [1986] 506 A.2d 173, 176*
[55] *Paramount Communications, Inc. v. Time [1989] 571 A.2d 1140, Unocal Corp. v. Mesa Petroleum Co. [1985] 493 A.2d 946*
[56] *DEAN (note 30) 155*
[57] *Ibid 18*
[58] *L. Mitchell 'Theoretical and practical framework for enforcing corporate constituency statutes' (1992) 70(3) Texas Law Review 579*
[59] *This non-interventionist policy (the internal management rule) was explained by Lord Eldon LC in Carlen v Drury (1812) 35 ER 61, who said: "This Court is not required on every Occasion to take the Management of every Playhouse and Brew house in the Kingdom."*
[60] *DEAN (note 30) 174.*

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