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The following issue is dedicated to the bright memory of the prominent representative of Georgian legal science, Professor Emeritus Guram Nachkebia



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Theories of Corporate Governance: A Legal Analysis

The purpose of those who rule is to lead the society to a better future, which can only be achieved via the methods and principles of good governance. One of the primary instruments via which good governance occurs in practice, is the adoption of legal acts by the branches of government. However, in order for the laws to have a positive effect on the future of the society, they must be based on solid theoretical bases.

In light of the aforesaid, it is quite problematic that quite often rules are adopted, which are based on theories, that the authors of such laws neglected to study and comprehend in depth. It is imprative that the fundamentals be understood better for good governance to occur. One of the fields in which there is somewhat of a lack of understanding of the basics in Georgia is that of corporate governance.

We can encounter extensive regulation in the field of corporate governance, both on the primary legislative level as well as in secondary legislation, in Georgia. Despite this, there is all but no academic literature available, which would analyze the differing, yet currently accepted theories of corporate governance. It is exactly the filling of this hole and the support for introducing the principles of good governance in the said field that is the primary aim of the research at hand.

Key words: Corporate, Governance, Theories, Analysis.

1. Introduction

The purpose of those who rule is to lead the society to a better future¹, which can only be achieved via the methods and principles of good governance². One of the primary instruments via which good governance occurs in practice, is the adoption of legal acts by the branches of government^{3,4}. However, in order for the laws to have a positive effect on the future of the society, they must be based on solid theoretical bases⁵.

Quite often, when working to create laws, the end result is based on the principles which are well analyzed and understood by both the legislator as well as third parties⁶. Unfortunately, this is not always the case and quite often new rules are adopted on the basis of theories which have not been studied and analyzed by the authors⁷. Alternatively, there are often occasions, when the legislative acts are being “transplanted”, which means that the national legal framework has laws of different states transferred into it, simply translating them instead of deeply and comprehensively studying them as well as the underlying principles thereof⁸. The practice of

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¹ *De Vries M.S.*, The Challenge of Good Governance, *The Innovation Journal: The Public Sector Innovation Journal*, 18.1., 2013, 2-9.

² *Hubbard R.*, Criteria of Good Governance *Optimum*, *The Journal of Public Management*, 30.2., 1999, 37-50.

³ *Weiss F., Steiner S.*, Transparency as an Element of Good Governance in the Practice of the EU and the WTO: Overview and Comparison, *Fordham International Law Journal*, 30.8., 2013, 1545-1586.

⁴ *Lane J.*, Good Governance: The Two Meanings of “Rule of Law”, *International Journal of Politics and Good Governance* 1.1., 2010, 1-27.

⁵ *Kessler F.*, Theoretic Bases of Law, *The University of Chicago Law Review*, 9, 1941, 98-112.

⁶ *Brust S.*, Ancient and Modern: Natural Law and Universal Moral Principles. *The Catholic Social Science Review*, 14, 2009, 65-74.

⁷ *Kessler F.*, Theoretic Bases of Law, *The University of Chicago Law Review*, 9, 1941, 98-112.

⁸ *Hendley K.*, Telephone Law and the Rule of Law: The Russian Case, *Hague Journal on the Rule of Law*, 1, 2009, 241-262.

legal transplantation was especially widely used in the republics of the former Soviet Union in the last decade of the twentieth century as well as the first decade of the twenty-first century⁹. In accordance with this existing practice, it is not particularly surprising that a number of Georgian legislative acts were adopted as a result of this instrument as well¹⁰. The field of corporate governance was not an exception here, where the original laws were created by mixing the legislative frameworks of Germany and Austria, which was later amended to include elements of the American rules as well¹¹.

The fact that a law is being adopted without its theoretical basis being comprehended, just by sharing the best practice of a different nation, does not mean that this very law must automatically be considered to be a bad one¹². Despite this, it is most definitely desirable, that the fundamental ideas be better understood, in order for good governance to be present¹⁴. Therefore, such a fact would better support and possibly even ensure that the brighter future for the state and the society is guaranteed¹⁵.

In practice, the level of understanding the theoretical fundamentals is everchanging¹⁶. It depends on the both on the country in question, as well as the topic which the laws at hand are to cover¹⁷. One of the fields in which there is somewhat of a lack of understanding of the basics in Georgia is that of corporate governance.

Corporate governance is defined as a system, via which a company is governed and controlled¹⁸. Any medium-sized and large company (as well as quite a few smaller companies) requires, for effective governance to be achieved, that the rights and competences of owners and managers be well defined and separated from each other¹⁹. A paramount aspect of corporate governance is the study of how, on what level, must the rights and obligations of the people involved be defined and the interests of which party should be considered to be the most important^{20,21}. In order for the approaches and the positions on these matters to be communicated well, the theories of corporate governance are created and evolved²². These theories are an important aspect of law and it is with their support that the relevant legislative acts are drafted in the best possible manner²³.

⁹ *Nichols P.M.*, The Viability of Transplanted Law: Kazakhstani Reception of a Transplanted Foreign Investment Code, University of Pennsylvania Journal of International Economic Law, 18.4., 1997, 1235-1279.

¹⁰ *Jupp J.*, Legal Transplants as Tools for Post-Conflict Criminal Law Reform: Justification and Evaluation, Cambridge Journal of International and Comparative Law, 3.1., 2014, 381-406.

¹¹ *Goshkheteliani N., Galdava D.*, Authorized Capital in Georgian Legislation – A Comparative Legal Analysis and an Alternative Regulation, Young Barristers Scientific Journal, 4, 2015, 33-42 (in Georgian).

¹² *Pangendler M.*, Politics in the Origins: The Making of Corporate Law in Nineteenth-Century Brazil, The American Journal of Comparative Law, 60, 2012, 805-850.

¹³ *Chiba M.*, Other Phases of Legal Pluralism in the Contemporary World, Ratio Juris: An International Journal of Jurisprudence and Philosophy of Law, 11.3., 1998, 228-245.

¹⁴ *Ballard M.J.*, Post-Conflict Property Restitution: Flawed Legal and Theoretical Foundations, Berkeley Journal of International Law, 28.2., 2010, 462-496.

¹⁵ *De Vries M.S.*, The Challenge of Good Governance, The Innovation Journal: The Public Sector Innovation Journal, 18.1., 2013, 2-9.

¹⁶ *Jupp J.*, Legal Transplants as Tools for Post-Conflict Criminal Law Reform: Justification and Evaluation, Cambridge Journal of International and Comparative Law, 3.1., 2014, 381-406.

¹⁷ *Pejovic C.*, Civil Law and Common Law: Two Different Paths Leading to the Same Goal, Victoria University of Wellington Law Review, 32, 2001, 817-842.

¹⁸ *Aggarwal P.*, Impact of Corporate Governance on Corporate Financial Performance, IOSR Journal of Business and Management, 13.3., 2013, 1-5.

¹⁹ *Kral P., Tripes S., Pirozek P., Pudil P.*, Corporate Governance Against Recommendations: The Cases of the Strong Executive and the Strong Ownership, Journal of Competitiveness, 4.3., 2012, 46-57.

²⁰ *Alam A., Shah S.*, Corporate Governance and its Impact on Firm Risk, International Journal of Management, Economics and Social Sciences, 2.2., 2013, 76-98.

²¹ *Marshall S., Ramsay I.*, Stakeholders and Directors' Duties: Law, Theory and Evidence, UNSW Law Journal, 35.1., 2012, 291-316.

²² *Abdullah H., Valentine B.*, Fundamental and Ethics Theories of Corporate Governance, Middle Eastern Finance and Economics, 4, 2009, 88-96.

²³ *Schleifer A., Vishny R.*, A Survey of Corporate Governance, The Journal of Finance, 52.2., 1997, 737-783.

We can encounter extensive regulation in the field of corporate governance, both on the primary legislative level as well as in secondary legislation, in Georgia. Despite this, there is all but no academic literature available, which would analyze the differing, yet currently accepted theories of corporate governance. It is exactly the filling of this hole and the support for introducing the principles of good governance in the said field that is the primary aim of the research at hand.

Theories of corporate governance can be separated into two specific types – primary and secondary theories²⁴. The primary theories are: Agency Theory, Stewardship Theory and Stakeholder Theory²⁵²⁶. As for secondary theories, they can be defined as follows: Resource Dependency Theory, Transaction Cost Theory, Political Theory, Legitimacy Theory, Social Contract Theory, Enlightened Stakeholder Theory and Ethics Theories²⁷²⁸²⁹.

In practice, it is the three primary theories that see usage both when drafting legislation, as well as with companies conducting business³⁰³¹. Despite this, the secondary theories are hugely important as well and in no way should they be ignored³²³³. Therefore, all of the aforementioned theories need to be critically analyzed and all relevant academic literature be scrutinized, in order for the information regarding this hugely important instrument of corporate law be more accessible in the academic literature of Georgia. This would, in turn, lead to the filling of the gap, which, as previously mentioned, is characteristic of the said field in the country.

The research at hand will critically analyze the primary as well as the secondary theories of corporate governance. They will be studied and both the positive and the negative aspects thereof be revealed. Additionally, this research will compare the current Georgian legislative framework and the existing realities to the demands of certain theories, in order to better define which of the principles can be seen in our laws, so to understand which theory the Georgian legislation is based on (as it is impossible to find information regarding this). Finally, if there are problems and inconsistencies with the legal basis of laws, the research at hand will provide recommendations regarding needed legislative amendments.

2. Methodology

There are two dominant approaches in academic literature regarding the methodology of research – qualitative and quantitative³⁴. The quantitative method primarily requires deductive reasoning, which means that when employed, it leads to the checking of merits of certain positions using hard, rigid data. As for the qualitative method, it has a

²⁴ *Letting N., Wasike E., Kinuu D., Murgor P., Ongeti W., Aosa E.*, Corporate Governance Theories and their Application to Boards of Directors: A Critical Literature Review, *Prime Journal of Business Administration and Management*, 2.12., 2012, 782-787.

²⁵ *Mamun A., Vasser Q., Rahman A.*, A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance, *Modern Economy*, 4, 2013, 37-48.

²⁶ *Donaldson L., Davis J.*, Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns, *Australian Journal of Management*, 16.1., 1991, 49-65.

²⁷ *Yussoff W., Alhaji I.*, Insight of Corporate Governance Theories, *Journal of Business & Management*, 1.1., 2012, 52-63.

²⁸ *Yilmaz A.*, Management Strategies for Resource Dependency Risk in Aviation Business, *International Review of Management and Business Research*, 3.3., 2014, 1551-1563.

²⁹ *Hung H.*, A Typology of the Theories of the Roles of Governing Boards, *Scholarly Research and Theory Papers*, 6.2., 1998, 101-111.

³⁰ *Connely B., Hoskisson R., Tihanyi L., Certo S.*, Ownership as a Form of Corporate Governance, *Journal of Management Studies*, 47.8., 2010, 1561-1589.

³¹ *Schleifer A., Vishny R.*, A Survey of Corporate Governance, *The Journal of Finance*, 52.2., 1997, 737-783.

³² *Letting N., Wasike E., Kinuu D., Murgor P., Ongeti W., Aosa E.*, Corporate Governance Theories and their Application to Boards of Directors: A Critical Literature Review, *Prime Journal of Business Administration and Management*, 2.12., 2012, 782-787.

³³ *Mamun A., Vasser Q., Rahman A.*, A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance, *Modern Economy*, 4, 2013, 37-48.

³⁴ *Wood M., Welch C.*, Are 'Qualitative' and 'Quantitative' Useful Terms for Describing Research? *Methodological Innovations Online*, 5.1., 2010, 56-71.

basis in inductive reasoning and is utilized in order to facilitate the building of theories, so that certain matters are better analyzed³⁵.

The quantitative method is most often used when research is being conducted in the field of exact sciences, while the qualitative approach is dominant with social sciences. This fact stems from the qualitative method having the more philosophical undertones, while its counterpart is most concerned with analyzing hard data³⁶. Jurisprudence is, of course, much closer to social sciences, so, unsurprisingly, it is the qualitative method that is considered to be the way to go with legal research³⁷. Considering the aforesaid, the research contained within the present document is conducted utilizing the qualitative method.

There are two types of instruments which tend to be used as a basis of academic research = primary and secondary sources³⁸. The primary sources are obtained by the researcher or their associates on the basis of sociological questionnaires, interviews and other similar methods. As for secondary sources, they consist of documents and instruments, that were previously created, independent of the research utilizing them and without the researcher's involvement³⁹. Due to the subject at hand, it would have been inexcusable to base the research on primary sources, as obtaining enough data is quite difficult and would have led to an absurdly huge waste of time and resources. Therefore, an optimal way would be the utilization of primarily secondary sources (laws, academic literature, court decisions etc.) when developing the research at hand.

There is one problem associated with using secondary sources – the issue of reliability⁴⁰. Since the author of the research and the source thereof are distinct individuals, there is always the threat that when writing, the given data will be incorrectly understood. Additionally, the source itself can be wrong, biased or incomplete⁴¹. Fortunately, in the era of the internet, it is much simpler to check and verify any given statement. Nevertheless, this research will endeavor as much as possible to utilize only those sources which are trustworthy and reliable. As a result, this potential issue should be remedied within this research.

As for the positive aspects of secondary sources, the simplicity of using them should be mentioned. This ease makes their utilization more effective, which affects the quality of the end product as well. The sources are created with the involvement of a number of scientists and researchers, which means that when using such documents, the author is presented not only with hard data, but also with the positions and approaches, which can have a considerable positive influence⁴². Additionally, the usage of the documents created by individuals working in a variety of fields helps the author in looking at the problem in a different light and to widen their horizon, which, of course, will be a positive development⁴³.

Finally, it must be noted that the majority of the research shall be conducted in the English language. As it has already been stated, there is a severe lack of relevant literature in Georgia. Additionally, since the theories of corporate governance have an international nature, it is more desirable for the research to be conducted in an

³⁵ *Johnson-Laird P.N.*, Deductive Reasoning, Annual Review of Psychology, 50, 1999, 109-135.

³⁶ *Hoepfl M.C.*, Choosing qualitative research: A Primer for Technology Education Researchers, Journal of Technology Education, 9.1., 1997, 47-63.

³⁷ *Johnson-Laird P.N.*, Deductive Reasoning, Annual Review of Psychology, 50, 1999, 109-135.

³⁸ *Long-Sutell T., Sque M., Addington-Hall J.*, Secondary Analysis of Qualitative Data: A Valuable Method for Exploring Sensitive Issues With an Elusive Population? Journal of Research in Nursing, 16.4., 2010, 335-344.

³⁹ *Church R.M.*, The Effective Use of Secondary Data, Journal of Learning and Motivation, 33, 2001, 32-45.

⁴⁰ *Drost E.A.*, Validity and Reliability in Social Science Research Education Research and Perspectives, 38.1., 2011, 105-122.

⁴¹ *Thomas S.L., Heck R.H.*, Analysis of Large-Scale Secondary Data in Higher Education Research: Potential Perils Associated with Complex Sampling Designs, Journal of Research in Higher Education, 42.5., 2001, 517-540.

⁴² *Choy L.T.*, The Strengths and Weaknesses of Research Methodology: Comparison and Complimentary between Qualitative and Quantitative Approaches, IOSR Journal Of Humanities And Social Science, 19.4., 2014, 99-104.

⁴³ *Andersen J.P., Prause J., Silver R.C.*, A Step-by-Step Guide to Using Secondary Data for Psychological Research, Social and Personality Psychology Compass, 5.1., 2010, 56-75.

international language as well. This, of course, can best be done in English. Despite of this, since mixed views and positions are a good thing for the research, it will also use Georgian, German, Russian and French sources.

3. Primary Theories of Corporate Governance

3.1. Etymology of Primary Theories

As it has already been clarified, there is almost no research conducted in Georgian on the subject of corporate governance theories. Therefore, there is no settled position on what exactly they should be called as well. The position of this research is that for the reader to be best able to understand the topic, the exact terms must be well thought-out. Therefore, this sub-paragraph exists in order to clarify which are the best the titles of corporate governance theories, as they are provided in the document at hand.

The agency theory is translated into Georgian as “Tsarmomadgenlis teoria”. This slightly differs from the exact translation from English, as that would have been “Agentobis teoria”. This very term can be seen as the “Principal-Agent-theorie”⁴⁴ in German, “Théorie de l’agence”⁴⁵ in French and “Теория агентства”⁴⁶ in Russian. They all sound similar to the rejected exact translation, so the reader may be confused as to why such a choice was made.

In the Russian language, the terms “агент” (agent) and “представитель” (representative), are, essentially, synonyms⁴⁷. The similar situation can be encountered in English as well^{48,49}. This considerably differs from Georgian, as the term directly corresponding with “agent” is not used in the same vein and mostly happens with insurance⁵⁰. Therefore, making a minor alteration is best advised so that the term makes most sense^{51,52}.

As for the stewardship theory, it can be seen in French as “théorie dite de l’intendance”⁵³ in German as “Stewardship Theorie”⁵⁴ and in Russian as “Управленческая теория”^{55,56}. The Georgian equivalent chosen “msakhuris teoria” or the “theory of a servant”, can also seem off-putting to some.

First, it needs to be emphasized that the term “steward” is, essentially, synonymous to “servant” in Georgian, so, if we rule out using foreign words, this would be an acceptable change. Also, when juxtaposing the theories of agency and stewardship, we often see the argument that according the latter, the director “serves”

⁴⁴ *Wenger E., Terberger E.*, Die Beziehung Zwischen Agent und Prinzipal als Baustein einer Ökonomischen Theorie der Organisation, *Wirtschaftswissenschaftliches Studium*, 17.10., 1990, 506-514.

⁴⁵ *Numa G.*, Théorie de l’agence et Concessions de Chemins de fer Français au 19^{ème} siècle, *Revue D’économie Industrielle*, 125, 2009, 105-128.

⁴⁶ *Капогузов Е.*, Вклад Новой Институциональной Экономической Теории в Реформирование Общественного Сектора, *Журнал институциональных исследований*, 3.4., 2011, 6-17.

⁴⁷ *Юрова К.И.*, Особенности Классификации Коллекторских Агентств и Организации Коллекторских Компаний, *Научно-практический журнал Государство и право в XXI веке*, 1, 2016, 27-31.

⁴⁸ *Emirbayer M., Mische A.*, What Is Agency? *The American Journal of Sociology*, 103.4., 1998, 962-1023.

⁴⁹ *Jensen M.C., Meckling W.H.*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, 3, 1976, 305-360.

⁵⁰ Georgian Civil Code, 1997, Article 805.

⁵¹ *Tchanturia L., Akhvlediani Z., Zoidze B., Jorbenadze S., Ninidze T.*, Commentary on the Georgian Civil Code, Book One, Tbilisi, Publishing House Samartali, 2002, 276-279.

⁵² Georgian Civil Code, 1997, Articles 103-114.

⁵³ *Cornforth C.*, La Gouvernance des Coopératives et des Sociétés Mutuelles: Une Perspective de Paradoxe, *Économie et Solidarités*, 35.6., 2005, 81-99.

⁵⁴ *Wald A.*, Corporate Governance als Erfolgsfaktor? *Industrielle Beziehungen*, 16.1., 2009, 67-86.

⁵⁵ *Васильев Ю.В., Парахина В.Н., Увицкий Л.И.*, Теория Управления, Издание Второе, Москва, Издательство Финансы и Статистика, 2005.

⁵⁶ *Чернышев М.А., Тяглое С.Г.*, Теория Организации, Ростов-на-Дону, Издательство Феникс, 2008.

the company^{57 58 59}, while the former considers that they generally do no such thing^{60 61 62 63}. Therefore, since the role of the director is foremost for these theories, using the term that best underlines their position should be the way to go.

As far as the stakeholder theory is concerned, it is translated into German as “stakeholder-theorie”^{64 65}, into French as “théorie des parties prenantes”⁶⁶ and into Russian as both “теория заинтересованных сторон”⁶⁷ and, alternatively, as “теория соучастников”⁶⁸.

As before, when discussing the term used by the research (“dainteresebuli pirebis teoria” or “theory of interested parties”), there can be questions raised by the readers. This is the best translation of the word “stakeholder” that we see in Georgian and best encapsulates its meaning, so the research considers it to be the best idea to utilize it⁶⁹.

In light of the aforesaid, this research considers that the terms used for the three primary theories are the best options available at this time.

3.2 Agency Theory

One of the primary topics covered by corporate law is the need for a rigid border between owning a share of the capital of a company and governing the said entity⁷⁰. The creation and delimitation of this rigid border in such a manner that the interests of the shareholders are best protected by the directors is the entire *raison d'être* of the agency theory⁷¹.

Company governance is defined as a broad array of matters related to the activity of a corporation⁷². It covers the planning of long-term matters with significant importance for the company, both large and small⁷³.

⁵⁷ Fox M.A., Hamilton R.T., Ownership and Diversification: Agency Theory or Stewardship Theory, *Journal of Management Studies*, 31.1., 1994, 69-81.

⁵⁸ Van Slyke D.M., Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship, *Journal of Public Administration Research and Theory*, 17, 2006, 157-187.

⁵⁹ Tudose M.B., Corporate Finance Theories, Challenges and Trajectories, *Management & Marketing Challenges for the Knowledge Society*, 7.2., 2012, 277-294.

⁶⁰ Letting N.K., Wasike E.R., Kinuu D., Murgor P., Ongeti W., Aosa E., Corporate Governance Theories and Their Application to Boards of Directors: A Critical Literature Review, *Prime Journal of Business Administration and Management*, 2.12., 2012, 782-787.

⁶¹ Pérez-González F., Inherited Control and Firm Performance, *American Economic Review*, 96.5., 2006, 1559-1588.

⁶² Boshkoshka M., The Agency Problem: Measures for Its Overcoming, *International Journal of Business and Management*, 10.1., 2015, 204-209.

⁶³ Davis J.H., Schoorman F.D., Donaldson L., Toward a Stewardship Theory of Management, *Academy of Management Review*, 22.1., 1997, 20-47.

⁶⁴ Göbel E., Der Stakeholderansatz im Dienste der Strategischen Früherkennung, *Zeitschrift für Planung*, 1, 1995, 55-67.

⁶⁵ Schaltegger S., Bildung und Durchsetzung von Interessen zwischen Stakeholder der Unternehmung, Eine Politisch-ökonomische Perspektive, *Die Unternehmung*, 53.1., 1999, 3-20.

⁶⁶ Mullenbach-Servayre A., L'apport de la Théorie des Parties prenantes à la Modélisation de la Responsabilité Sociétale des Entreprises, *Revue des Sciences de Gestion*, 223, 2007, 109-120.

⁶⁷ Благоев Ю.Е., Классика Теории Менеджмента, *Вестник Санкт-Петербургского Университета*, 1, 2012, 109-116.

⁶⁸ Леванов Л.Н., Теоретико-Методологические Подходы к Понятию “Корпоративное Управление”, *Известия Саратовского Университета*, 12.1., 2012, 54-60.

⁶⁹ Wang B., Theme in Translation: A Systemic Functional Linguistic Perspective, *International Journal of Comparative Literature & Translation Studies*, 2.4., 2014, 54-63.

⁷⁰ Fama E.F., Jensen M.C., Separation of Ownership and Control, *Journal of Law and Economics*, 26.2., 1983, 301-325.

⁷¹ Bonazzi L., Islam S.M.N., Agency Theory and Corporate Governance: A Study of the Effectiveness of Board in Their Monitoring of the CEO, *Journal of Modelling in Management*, 2.1., 2007, 7-23.

⁷² Стрекалова А.А., Второе Поколение Фискального Федерализма, *Журнал Human Progress*, 2.3., 2016, 1-12.

⁷³ Namazi M., Role of the Agency Theory in Implementing Management's Control, *Journal of Accounting and Taxation*, 5.2., 2003, 38-47.

In light of all this, it is quite clear that corporate governance is of tremendous importance and the fundamental theories thereof need to be wholly understood so that a field of law covering such matters does not become similar to a castle built on sand⁷⁴.

The agency theory has been used in economics and law for quite some time⁷⁵. Despite this, there are quite a few parties who oppose this instrument, as they believe that the agency theory dehumanizes the individuals involved in corporate governance, because of which this theory is considered to be dangerous and undesirable⁷⁶.

The Agency theory is often seen as an instrument which should be utilized in order to fix the problems which arise in three specific situations. These are:

1. When the interests of the company and its shareholders are not concurrent with each other;
2. When the members of the company are unable to effectively monitor those governing the corporation;
3. When the positions of the shareholders and the directors differ on certain risky actions that the company may need to undertake⁷⁷.

This following research was undertaken in order to describe the positions on these matters, in accordance with the agency theory, as well as to critically evaluate the positive and negative aspects thereof.

3.2.1 The Agency Theory and the Conflict of Interest

As far as the agency theory is concerned, the conflict of interests is generally caused by the fact that a company is a distinct entity and should not be considered to be the sum of its shareholders⁷⁸. More specifically, a problem arises from the fact that, quite often, the interests of the shareholders do not coincide with that of the company itself. The shareholders often prefer short-term gains while neglecting the long-term goals⁷⁹. This may become a problem as, without a deep comprehension of the theories of corporate governance, it is immensely difficult to discuss which side should the director side with and who's positions must be protected by them, shareholders or the company itself⁸⁰.

The agency theory has a concrete standing on this matter. It stems from the primary idea of the theory that the director is an agent, a representative of the shareholders⁸¹. This means that, according to this doctrine, the director needs to worry about the interests of the shareholders, not the company at large⁸². In light of this, one can say that the company itself becomes a third party for the director, as they are always obliged to emphasize the interests of their principals – the shareholders⁸³ (This position is shared in Georgian academic literature as well⁸⁴), and, therefore, it becomes clear that the director must only care for the well-being of the shareholders.

⁷⁴ *Baiman S.*, Agency Research in Managerial Accounting: A Second Look Accounting, Organization and Society, 15.4., 1990, 341-371.

⁷⁵ *Spence A.M., Zeckhauser R.*, Insurance, Information and Individual Action, American Economic Review, 61, 1971, 380-387.

⁷⁶ *Perrow C.*, Complex Organizations, New York, Random House, 1986.

⁷⁷ *Eisenhardt K.*, Agency Theory: An assessment and a review, Academy of Management Review, 14.1., 1989, 57-74.

⁷⁸ *Daly H.*, Conflicts of Interest in Agency Theory: A Theoretical Overview, Global Journal of Human-Social Science: Economics, 15.1., 2015, 17-22.

⁷⁹ *Fama E.F., Jensen M.C.*, Separation of Ownership and Control. Journal of Law and Economics, 26.2., 1983, 301-325.

⁸⁰ *Fama E.F.*, Agency Problems and the Theory of the Firm, Journal of Political Economy, 88, 1980, 288-307.

⁸¹ *Baiman S.*, Agency Research in Managerial Accounting: A Second Look, Accounting, Organization and Society, 15.4., 1990, 341-371.

⁸² *Eisenhardt K.*, Agency Theory: an Assessment and a Review, Academy of Management Review, 14.1., 1989, 57-74.

⁸³ *Keser C., Willinger M.*, Theories of Behavior in Principal-Agent Relationships with Hidden Action, European Economic Review, 51., 2007, 1514-1533.

⁸⁴ *Tchanturia L., Akhvlediani Z., Zoidze B., Jorbenadze S., Ninidze T.*, Commentary on the Georgian Civil Code, Book One, Tbilisi, Publishing House Samartali, 2002, 276-279.

As for the company at large, it is important as well, but when presented with the need to protect it or the shareholders, the director must always stick with the latter⁸⁵.

In light of the aforesaid, one should note that when there is a conflict of interests between the shareholders and the company, the agency theory offers a simple solution. The director must always do anything in their power to make sure that the outcome is favorable to the shareholders, no matter the cost thereof for the company.

3.2.2 The Agency Theory and the Control of the Directors by the Shareholders

One characteristic of the Agency theory is that it assumes the directors to be self-serving and self-interested. It considers that without supervision and control, those governing a company will strive to ensure the outcome of any action to be most desirable for themselves, not the shareholders⁸⁶. In light of this, an effective supervision structure to be employed by the shareholders becomes paramount⁸⁷.

In accordance with the agency theory for the directors to govern the company in a way that the shareholders would prefer, it is important for effective supervision mechanisms to be put into force⁸⁸. Without them there will be a considerable chance that the director will take steps which are selfish and go against the shareholders' needs⁸⁹ or, at the very least, will not do everything in their power to support the interests of their principals⁹⁰.

The agency theory states that the shareholder will never be able to protect their interests perfectly via individuals hired and employed⁹¹. Therefore, the owners of the company will need to play an active role in the life of the organization⁹², or, if this is impossible, they should at least use the instruments that will allow them to often check the work of the directors in an efficient manner⁹³. Both alternatives require for the shareholders to use additional resources (their time or finances), but, as far as the agency theory is concerned, these are justified since this will help ensure the effective governance of the company, so that the shareholders' interests are best protected⁹⁴. The theory also considers the possibility that additional oversight instruments will diminish the effectiveness of governance, but this is seen as an acceptable sacrifice⁹⁵, so that the directors' loyalty and dedication to the company is ensured.

One other matter, which deals with the directors working to ensure the shareholder's best interests being met is that, in accordance with the agency theory, the directors require additional incentives in order for them to do their duty effectively⁹⁶. As it has already been stated, the director is considered to be selfish⁹⁷. Therefore, for the company to be governed in the best manner, it is imperative that the interests of the corporation coincide

⁸⁵ *Jensen M.C., Meckling W.H.*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, 3, 1976, 305-360.

⁸⁶ *Pfeffer J.*, *Power in Organizations*, Marshfield, Massachusetts, Pitt-Man Publishing, 1981.

⁸⁷ *Aggarwal S., Goel R., Vashishtra, P.K.*, A Literature Review of Agency Theory, *Indian Journal of Research*, 3.5., 2014, 51-52.

⁸⁸ *Caers R., Du Bois C., Jegers M., De Gieter S., Schepers C., Pepermans R.*, Principal-Agent Relationships on the Stewardship-Agency Axis, *Nonprofit Management & Leadership*, 17.1., 2006, 25-47.

⁸⁹ *Allen F., Bernardo A.E., Welch I.*, A Theory of Dividends Based on Tax Clienteles, *The Journal of Finance*, 55.6., 2000, 2499-2536.

⁹⁰ *Eisenhardt K.*, Agency Theory: an Assessment and a Review, *Academy of Management Review*, 14.1., 1989, 57-74.

⁹¹ *Rose P.*, Common Agency and the Public Corporation, *Vanderbilt Law Review*, 63.5., 2010, 1355-1417.

⁹² *Davis G.F., Thompson T.A.*, A Social Movement Perspective on Corporate Control, *Administrative Science Quarterly*, 39.1., 1994, 141-173.

⁹³ *Al-Matari M., Al-Swidi A.K., Fadzil F.H.B.*, The Effect of the Internal Audit and Firm Performance: A Proposed Research Framework, *International Review of Management and Marketing*, 4.1., 2014, 34-41.

⁹⁴ *Shapiro S.P.*, Agency Theory, *Annual Review of Sociology*, 31, 2005, 263-284.

⁹⁵ *Hadani M., Horanova M., Khan R.*, Institutional Investors, Shareholder Activism, and Earnings Management, *Journal of Business Research*, 64, 2011, 1352-1360.

⁹⁶ *Prendergast C.*, The Provision of Incentives in Firms, *Journal of Economic Literature*, 37.1., 1999, 7-63.

⁹⁷ *Pfeffer J.*, *Power in Organizations*, Marshfield, Massachusetts, Pitt-Man Publishing, 1981.

with those of the directors⁹⁸. Additional incentives can be used to ensure this, such as their payment being “tied” to the success of the company⁹⁹ or any other outcome that the shareholders find desirable¹⁰⁰.

Despite the aforesaid, the proponents of the agency theory also emphasize that the directors’ incentives should not be tied to any specific details of the company’s work. This stems from the simple fact that if there is one concrete goal that the directors are required to achieve, they will only focus on it, neglecting their other duties, which will be to the detriment of the corporation¹⁰¹. In light of this, the best approach would be to tie the directors’ pay to the income the shareholders accrue from the company¹⁰², without specifying anything else. This, according to the agency theory, will lead to the corporation being governed in a manner most desirable to its owners, despite them having a relatively small role in its governance.

3.2.3 The Agency Theory and Risk Allocation

A major dilemma for corporate law is that of risk allocation among the directors and the shareholders¹⁰³. An issue presents itself when discussing which party should be the responsible one with the decisions which stem from risky actions¹⁰⁴.

This subject is relevant partly because, even if the payment of the directors is tied to the success of the company, there is still a chance that they will take unacceptably big risks when doing their work¹⁰⁵. While the interests of the shareholders and the company itself are not always in alignment¹⁰⁶, they are still more interested in the success of the corporation, more so than the directors¹⁰⁷. This stems from the fact that the shareholder has invested time, energy and capital in the company, while the investment of the director is limited to the former two¹⁰⁸. As a result, while the agency theory postulates that tying the directors’ salary to the success of the company is a good idea, this does nothing to diminish the possibility of them taking steps that are too risky.

This problem can be somewhat mitigated with the responsibility for such actions being shifted to the directors themselves¹⁰⁹. With such an approach, when the director feels that, if they take undue risks, they will be likely to bear the results as well, they will become more conservative in their actions and take no undue risks, which will benefit the company¹¹⁰. This is the position provided by the agency theory, which states that it would be the best approach to take if the success of the company determines the director’s salary and, at the same time, saddles them with the outcomes of the risks they are to take. This will ensure that the directors are as responsible as possible and fulfill their fiduciary duties as effectively and efficiently as can be expected¹¹¹.

⁹⁸ *Prendergast C.*, The Provision of Incentives in Firms, *Journal of Economic Literature*, 37.1., 1999, 7-63.

⁹⁹ *Eisenhardt K.*, Agency Theory: an Assessment and a Review, *Academy of Management Review*, 14.1., 1989, 57-74.

¹⁰⁰ *Prendergast C.*, The Provision of Incentives in Firms, *Journal of Economic Literature*, 37.1., 1999, 7-63.

¹⁰¹ *Milgrom P.*, Employment Contracts, Influence Activity and Efficient Organization, *Journal of Political Economy*, 96, 1988, 42-60.

¹⁰² *Eisenhardt K.*, Agency Theory: an Assessment and a Review, *Academy of Management Review*, 14.1., 1989, 57-74.

¹⁰³ *Goel A.M., Thakor A.J.*, Overconfidence, CEO Selection and Corporate Governance, *The Journal of Finance*, 63.6., 2008, 2737-2784.

¹⁰⁴ *Jensen M.C., Meckling W.H.*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics*, 3, 1976, 305-360.

¹⁰⁵ *Prendergast C.*, The Provision of Incentives in Firms, *Journal of Economic Literature*, 37.1., 1999, 7-63.

¹⁰⁶ *Fama E.F., Jensen M.C.*, Separation of Ownership and Control, *Journal of Law and Economics*, 26.2., 1989, 301-325.

¹⁰⁷ *Bitler M.P., Moskowitz T.J., Vissing-Jorgensen A.*, Testing Agency Theory with Entrepreneur Effort and Wealth, *The Journal of Finance*, 60.2., 2006, 539-576.

¹⁰⁸ *Wright P., Mukherji A., Kroll M.J.*, A Reexamination of Agency Theory Assumptions: Extensions and Extrapolations, *Journal of Socio-Economics*, 30, 2001, 413-429.

¹⁰⁹ *Васильев Ю.В., Парахина В.Н., Ушвицкий Л.И.*, Теория Управления, Издание Второе, Москва, Издательство Финансы и Статистика, 2005.

¹¹⁰ *Palia D., Porter R.*, Agency Theory in Banking: An Empirical Analysis of Moral Hazard and the Agency Costs of Equity, *Banks and Bank Systems*, 2.3., 2007, 142-156.

¹¹¹ *Eisenhardt K.*, Agency Theory: An Assessment and a Review, *Academy of Management Review*, 14.1., 1989, 57-74.

3.2.4 Summary of the Agency Theory

The aforesaid ideas and opinions are the primary characteristics of the Agency theory, which are relevant to corporate governance. As a result, they can be summarized in this sub-paragraph as follows:

1. The director represents and protects the interests of the shareholders, not the company itself.
2. Those doing the governance of the company are responsible towards the shareholders, but they hold their own interests more dear, which means that they require supervision. This can be done personally by the shareholders, or by creating alternative mechanisms.
3. Supervision may be insufficient to ensure the fiduciary duties being met, because of which it is required for the directors to be granted additional incentives in order for their interests to coincide with those of the shareholders. This can be done by “tying” the directors’ salaries to the success of the company.
4. The director can take undue risks when leading the company, therefore, it is imperative that the results of these risks reflect upon the individual taking them. Therefore, it is the directors who should bear responsibility for the risky actions undertaken by the company.

3.3 Stewardship Theory

The stewardship theory was first established in the treatises in the fields of psychological and sociological studies¹¹², unlike the agency theory, which was formulated by economists¹¹³. Considering this fact, it is unsurprising that the two theories often have radically different approaches¹¹⁴. When analyzing the stewardship theory, it is often juxtaposed with the agency theory, in order to emphasize the differences and incompatibilities between the two doctrines¹¹⁵.

The stewardship theory has a number of opponents, who criticize its ideas and proposals, as well as its underlining motives¹¹⁶. These individuals hold that, the stewardship theory is naïve, overly optimistic¹¹⁷ and fails to appreciate the self-centered and self-interested nature of the directors¹¹⁸. It should be noted, that when comparing it to the agency theory, it has somewhat fewer critics¹¹⁹, but this should not be misconstrued to mean that, due to fewer people disliking it, the stewardship theory is in any way superior.

As it has been stated above, the stewardship theory puts an emphasis on the relationship between the shareholders and the directors. This differs from the agency theory, where the dynamic between the company and those governing it is more prominent¹²⁰. The stewardship theory discusses a number of matters, which stem from this relationship, and attempts to solve the issues which arise in the following situations¹²¹:

¹¹² *Donaldson L., Davis J.*, Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns, Australian Journal of Management, 16.1., 1991, 49-65.

¹¹³ *Al-Mamun A., Yasser Q.R., Rahman A.*, A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance, Modern Economy, 4, 2013, 37-48.

¹¹⁴ *Van Slyke D.M.*, Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship, Journal of Public Administration Research and Theory, 17, 2006, 157-187.

¹¹⁵ *Fox M.A., Hamilton R.T.*, Ownership and Diversification: Agency Theory or Stewardship Theory, Journal of Management Studies, 31.1., 1994, 69-81.

¹¹⁶ *Davis J.H., Schoorman F.D., Donaldson L.*, Toward a Stewardship Theory of Management, Academy of Management Review, 22.1., 1997, 20-47.

¹¹⁷ *Tourani-Rad A., Ingley C.*, Handbook on Emerging Issues in Corporate Governance, Singapore, World Scientific Publishing Co, 2011.

¹¹⁸ *Du Plessis J., McConvill J., Bagaric M.*, Principles of Contemporary Corporate Governance, New York, Cambridge University Press, 2005.

¹¹⁹ *Tourani-Rad A., Ingley C.*, Handbook on Emerging Issues in Corporate Governance, Singapore, World Scientific Publishing Co., 2011.

¹²⁰ *Yusoff W., Alhaji I.*, Insight of Corporate Governance Theories, Journal of Business & Management, 1.1., 2012, 52-63.

¹²¹ *Donaldson L., Davis J.*, Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns, Australian

1. When the interests of the shareholders differ from those of the company itself (just like the agency theory);
2. When the shareholders are attempting to limit the freedom to act of the directors of the company;

3.3.1 The Stewardship Theory and the Conflict of Interest

Just like the agency theory, the stewardship theory recognizes the possibility that the interests of the shareholders differ from those of the company¹²². In such cases, the doctrine at hand postulates that the shareholders are obliged to work in the interests of the company, not the shareholders¹²³, which stems from the central idea of the stewardship theory, which states that the director is not a representative or an agent of the shareholders, instead being a steward of the company itself¹²⁴.

The agency theory emphasizes the fact that when governing the corporation, the director must always be striving to protect and support the interests of the shareholders¹²⁵. This can be juxtaposed with the stewardship theory, which takes up a directly opposing view¹²⁶. It postulates that the function of the individuals governing the corporation is to ensure that the company is as successful as it can ever be, obtaining the maximum possible income¹²⁷, but this does not always mean that the director will undertake actions which the shareholders like the most¹²⁸. The stewardship theory states that the director must serve the company and protect its interests, considering the corporation as an entity wholly separate and independent of its shareholders¹²⁹. The interests of the company and its owners often coincide, as both would like to gain as much capital as possible, but the stewardship theory demands, that once this correlation is no longer there, the director must always side with the company against its shareholders¹³⁰.

3.3.2 The Stewardship Theory and the Trustworthiness and Freedom of the Directors

A central idea of the agency theory is that of shareholders controlling the directors¹³¹, as, in accordance with this doctrine, a director who is not tightly controlled, will cease to act in the interests of their employers and will only serve their own personal interests¹³². The stewardship theory disagrees and postulates that the director, generally, is a trustworthy person, who needs freedom and support instead of being controlled¹³³.

Journal of Management, 16.1., 1991, 49-65.

¹²² *Muth M.M., Donaldson L.*, Stewardship Theory and Board Structure: A Contingency Approach, Scholarly Research and Theory Papers, 6.1., 1998, 5-28.

¹²³ *Nordberg D.*, The Ethics of Corporate Governance, Journal of General Management, 33.4., 2008, 35-52.

¹²⁴ *Quinn E.*, The Complex Relationship between Corporate Management, Stakeholders and Accounting, International Journal of Academic Research in Accounting, Finance and Management Sciences, 4.3., 2014, 80-88.

¹²⁵ *Eisenhardt K.*, Agency Theory: An Assessment and a Review, Academy of Management Review, 14.1., 1989, 57-74.

¹²⁶ *Виханский О.С., Наумов А.И.*, Размышления о Менеджменте - "Другой" Менеджмент: Время Перемен, Российский Журнал Менеджмента, 3, 2004, 105-126.

¹²⁷ *Biesenthal C., Wilden R.*, Multi-level Project Governance: Trends and Opportunities, International Journal of Project Management, 32.8., 2014, 1291-1308.

¹²⁸ *Hiebl M.R.W.*, Peculiarities Of Financial Management In Family Firms, International Business & Economics Research Journal, 11.3., 2012, 315-322.

¹²⁹ *Van Slyke D.M.*, Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship, Journal of Public Administration Research and Theory, 17, 2006, 157-187.

¹³⁰ *Quinn E.*, The Complex Relationship between Corporate Management, Stakeholders and Accounting, International Journal of Academic Research in Accounting, Finance and Management Sciences, 4.3., 2014, 80-88.

¹³¹ *Caers R., Du Bois C., Jegers M., De Gieter S., Schepers C., Pepermans R.*, Principal-Agent Relationships on the Stewardship-Agency Axis, Nonprofit Management & Leadership, 17.1., 2006, 25-47.

¹³² *Allen F., Bernardo A.E., Welch I.*, A Theory of Dividends Based on Tax Clienteles, The Journal of Finance, 55.6., 2000, 2499-2536.

¹³³ *Albrecht W.S., Albrecht C.C., Albrecht C.O.*, Fraud and Corporate Executives: Agency, Stewardship and Broken Trust, Journal of Forensic Accounting, 5, 2004, 109-130.

The stewardship theory considers it a settled fact that the director serves the company. This means that they are obliged to act in the interests of the corporation and, no less importantly, that they will be willing to do so even without any meaningful supervision. The stewardship theory considers that the director is more likely to serve the company than themselves¹³⁴. The director is considered to be the person who sees the well-being of the company as their personal mission¹³⁵. The stewardship theory, essentially, sees the director as an honest and kind individual, who will use all of their powers to support the company and its interests¹³⁶. Therefore, there is no basis for the shareholders to doubt the director or the fact that this individual will fulfill their fiduciary duties. This means that the stewardship theory does not see the supervision of the director to be needed in any way¹³⁷.

This approach is directly opposite to the one adopted by the agency theory¹³⁸. While the agency sees them as selfish, the stewardship theory essentially considers the directors to be entirely selfless¹³⁹. In light of this, the stewardship theory is against the shareholders using their powers to control the directors¹⁴⁰. It postulates that such mechanisms are an unacceptable waste of the company's resources¹⁴¹. Additionally, the stewardship theory is opposed to the shareholders' interference on the basis of such actions not only failing to improve anything, but also their involvement actively harming the company and reducing its income¹⁴² and lowering the efficiency of its actions¹⁴³, something that harms to company and, therefore, is unacceptable to the doctrine at hand¹⁴⁴.

In light of the aforesaid, it can be stated that, according to the stewardship theory, even an attempt to control the director should be considered a bad thing and there is no need whatsoever for the shareholders to get directly involved in the daily life of the company¹⁴⁵. No resources should be wasted to create and maintain a mechanism which would be acting as an intermediary between the shareholders and the director, simply for it to better facilitate the shareholders playing a larger role in the running of the company as, in accordance with the stewardship theory, them being involved is not great for the interests of the company¹⁴⁶.

One other issue that needs to be emphasized is that of trust and risk. The stewardship theory states that the director deserves all the trust they can get from the shareholders. This includes the shareholders accepting the fact that the director will always work for the interests of the company, therefore, not needing any additional

¹³⁴ *Al-Mamun A., Yasser Q.R., Rahman A.*, A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance, *Modern Economy*, 4, 2013, 37-48.

¹³⁵ *Quinn E.*, The Complex Relationship between Corporate Management, Stakeholders and Accounting, *International Journal of Academic Research in Accounting, Finance and Management Sciences*, 4.3., 2014, 80-88.

¹³⁶ *Albrecht W.S., Albrecht C.C., Albrecht C.O.*, Fraud and Corporate Executives: Agency, Stewardship and Broken Trust, *Journal of Forensic Accounting*, 5, 2004, 109-130.

¹³⁷ *Muth M.M., Donaldson L.*, Stewardship Theory and Board Structure: A Contingency Approach, *Scholarly Research and Theory Papers*, 6.1., 1998, 5-28.

¹³⁸ *Spahaj E.*, Empirical Data on the Correlation between CEO Duality and the Performance of a Corporation, *European Journal of Interdisciplinary Studies*, 2.1., 2015, 55-61.

¹³⁹ *Al-Mamun A., Yasser Q.R., Rahman A.*, A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance, *Modern Economy*, 4, 2013, 37-48.

¹⁴⁰ *Donaldson L., Davis J.*, Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns, *Australian Journal of Management*, 16.1., 1991, 49-65.

¹⁴¹ *Costa M.D.*, Impact of CEO Duality and Board Independence on FTSE Small Cap & Fledgling Company Performance, *World Review of Business Research*, 5.1., 2015, 1-19.

¹⁴² *Moscu R.G.*, Does CEO Duality Really Affect Corporate Performance? *International Journal of Academic Research in Economics and Management Sciences*, 2.1., 2013, 156-166.

¹⁴³ *Ugwoke R.O., Onyeamu E.O., Obodoekwe C.N.*, Duality Role of Chief Executive Officer (CEO) in Corporate Governance and Performance of Quoted Companies in the Nigerian Stock Exchange: An Appraisal of the Perception of Managers and Accountants, *Global Journal of Management and Business Research Accounting and Auditing*, 13.5., 2013, 1-10.

¹⁴⁴ *Vo T.N.T.*, To Be or Not to Be Both CEO and Board Chair, *Brooklyn Law Review*, 76.1., 2010, 65-129.

¹⁴⁵ *Masry M.*, The Impact of Ownership Duality on Firm Performance in Egypt, *International Journal of Accounting and Taxation*, 3.1., 2015, 54-73.

¹⁴⁶ *Vo T.N.T.*, To Be or Not to Be Both CEO and Board Chair, *Brooklyn Law Review*, 76.1., 2010, 65-129.

incentives or anything of the kind to facilitate their wishes being in line with those of the corporation¹⁴⁷. This doctrine states that the potential bonuses and awards do not correlate with the success of the company because, as it has been stated numerous times, the director already does their best for the corporation¹⁴⁸.

As far as risk is concerned, the stewardship theory opposes the agency theory in this as well. Since the director is assumed to always be acting in the best interest of the company, there is no need to put any blame on them should some risks that have been taken turn out to be detrimental to the company¹⁴⁹. If unwarranted steps are taken, this will result in the corporation suffering, but this should not result in the director being made a scapegoat.

3.3.3 Summary of the Stewardship Theory

The positions that have been discussed above, are considered to be the primary aspects of the stewardship theory in the current academic literature. In light of this, the stewardship theory can be summarized as follows:

1. The director serves the company, instead of being a representative of the shareholders.
2. The director always strives to serve the corporation's interests, seeing them as more important than their own selfish desires.
3. The shareholders should trust the director to act in accordance with the company's needs.
4. There is no need for the shareholders to get involved in the life of the company in order to control the director.
5. It is inexcusable for new instruments and mechanisms to be created and the company's resources being wasted on them just because the shareholders can oversee the director.
6. The salary of the director does not correlate with their wish to serve the company, therefore, there is no need for additional incentives to be given to them.
7. The director always works for the company, so they will never take unwarranted risks. Therefore, saddling them with the consequences of these risks is unacceptable, as this will limit the much-needed freedom of the directors.

3.4 Stakeholder Theory

The stakeholder theory differs from both the stewardship theory as well as the agency theory in a major way. These two essentially discuss similar matters, but take opposing views¹⁵⁰, while the stakeholder theory emphasizes completely different issues¹⁵¹. The two aforesaid theories are focused on the relationship between the shareholders and the director, while the stakeholder theory involves a number of additional entities¹⁵². There is some similarity between the stakeholder and stewardship theories, but, as stated before, they have completely different approaches to the fundamental matters of corporate governance¹⁵³. Unlike its counterparts, the stakeholder theory discussed matters such as the purpose of corporate governance, interests of third parties and the ethical dimension of the directors' actions¹⁵⁴.

¹⁴⁷ *Felicio J.A., Rodrigues R., Study on The Influence of Governance Mechanisms on Performance: Evidence of Nonlinear Relationships of Listed Companies in Different Contexts, Corporate Ownership & Control, 11.2., 2014 429-532.*

¹⁴⁸ *Васильев Ю.В., Парахина В.Н., Ушвицкий Л.И., Теория Управления, Издание Второе, Москва, Издательство Финансы и Статистика, 2015.*

¹⁴⁹ *Aduda J., Chogii R., Maguta P.O., An Empirical Test of Competing Corporate Governance Theories on the Performance of Firms Listed at the Nairobi Securities Exchange, European Scientific Journal, 9.13., 2013, 107-137.*

¹⁵⁰ *Fox M.A., Hamilton R.T., Ownership and Diversification: Agency Theory or Stewardship Theory, Journal of Management Studies, 31.1., 1994, 69-81.*

¹⁵¹ *Чернышев М.А., Тяглое С.Г., Теория Организации, Ростов-на-Дону, Издательство Феникс, 2008.*

¹⁵² *Белобородова А.Л., Специфика Применения Теории Заинтересованных Сторон В Управлении Субъектами Малого Предпринимательства, Казанский Экономический Вестник, 5.7., 2013, 78-82.*

¹⁵³ *Freeman R.E., Strategic Management: A stakeholder Approach, Boston, Pitman Publishing, 1984.*

¹⁵⁴ *Sundaram A.K., Inkpen A.C., Stakeholder Theory and The Corporate Objective Revisited: A Reply Organization Sci-*

The stakeholder theory is considerably newer than other primary theories of corporate governance¹⁵⁵. This means that there has been much less usage thereof in practice, something that is often emphasized in academic literature¹⁵⁶. Despite this, it has already accrued a number of opponents who prefer using the more traditional mechanisms, while considering the stakeholder theory an unwanted and unprofitable novelty¹⁵⁷.

Unlike the previously discussed two instruments, there is no settled discourse regarding stakeholder theory in academic literature¹⁵⁸, something that makes deliberating about it quite difficult. This research provides an analysis of the more widespread and recognized positions regarding the doctrine at hand.

3.4.1 The Stakeholder Theory and the Purpose of Corporate Governance

Both the agency and stewardship theories agree that the purpose of the director is to make it so that the economic activities led by him result in as much income as possible (differing only on who should be accruing the wealth)¹⁵⁹. The only primary corporate governance theory that disagrees with this is the stakeholder theory¹⁶⁰.

The stakeholder theory holds that the directors must make decisions which are aimed at not just making money for someone, but at ensuring the well-being of all parties that have a stake in the company¹⁶¹. This stems from the approach that, according to the stakeholder theory, the purpose of corporate governance is not to make money. It rejects such an attitude and postulates that the purpose of corporate governance is to balance the interests of all parties involved, so that the outcome is favorable to all¹⁶². This means that, in accordance with the doctrine at hand, the dominant “value maximization” approach is rejected¹⁶³ and a wider definition of the directors’ duties is used¹⁶⁴.

These attitudes stem from the fact that, in accordance with the stakeholder theory, a company and, as an extension thereof, its director has the obligation to the wider society. It states that the business has a duty to care for third parties, while rejecting the “value maximization” theory as immoral and unacceptable¹⁶⁵. Additionally, those in favor of the stakeholder theory believe that the economic crises of the twentieth and the twenty-first centuries were the “fault” of the agency and stewardship theories¹⁶⁶, which stems from these instruments being focused on accruing money, which leads to those leading businesses to becoming greedy, something that harms the global economy¹⁶⁷. Therefore, they see the “value maximization” theory as a problem in itself and propose

ence, 15.3., 2004, 370-371.

¹⁵⁵ *Rensburg R.R., De Beer E.*, Stakeholder Engagement: A Crucial Element in the Governance of Corporate Reputation, *Communitas*, 16, 2011, 151-169.

¹⁵⁶ *Setyorini C.T., Ishak Z.*, Corporate Social and Environmental Disclosure: A Positive Accounting Theory View Point, *International Journal of Business and Social Science*, 3.9., 2012, 152-164.

¹⁵⁷ *Reynolds S.J., Schultz F.C., Hekman D.R.*, Stakeholder Theory and Managerial Decision-Making: Constraints and Implications of Balancing Stakeholder Interests, *Journal of Business Ethics*, 64, 2006, 285-301.

¹⁵⁸ *Donaldson T., Preston L.E.*, The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications, *The Academy of Management Review*, 20.1., 1995, 65-91.

¹⁵⁹ *Виханский О.С., Наумов А.И.*, Размышления о Менеджменте - “Другой” Менеджмент: Время Перемен, *Российский Журнал Менеджмента*, 3, 2004, 105-126.

¹⁶⁰ *Brown J.A., Forster W.R.*, CSR and Stakeholder Theory: A Tale of Adam Smith, *Journal of Business Ethics*, 112.2., 2011, 301-312.

¹⁶¹ *Jensen M.C.*, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, *Business Ethics Quarterly*, 12.2., 2002, 235-256.

¹⁶² *Hitt M., Freeman E., Harrison J.*, *Handbook of Strategic Management*, Oxford, Blackwell Publishing, 2001.

¹⁶³ *Allen W.T.*, Contracts and Communities in Contract Law, *Washington Lee Law Review*, 50, 1993, 1395-1407.

¹⁶⁴ *Clarkson M.B.E.*, A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance, *Academic Management Review*, 20, 1995, 92-117.

¹⁶⁵ *Ferrero I., Hoffman W.M., McNulty R.E.*, Must Milton Friedman Embrace Stakeholder Theory? *Business and Society Review*, 119.1., 2004, 37-59.

¹⁶⁶ *Shim E.D.*, Sustainability, Stakeholder Perspective and Corporate Success: A Paradigm Shift, *International Journal of Business, Humanities and Technology*, 4.5., 2014, 64-67.

¹⁶⁷ *Sundaram A.K., Inkpen A.C.*, Stakeholder Theory and The Corporate Objective Revisited: A Reply, *Organization Sci-*

to discard it, placing the stakeholder theory as the dominant doctrine¹⁶⁸. They see such changes as admirable in both an economic as well as the moral sense^{169,170}, something that makes them all the more desirable.

Despite the aforesaid, however, the dominant approach to the stakeholder theory is that it is impractical and unrealistic in an economic sense¹⁷¹. The director is more able to do their duty when they have a single purpose to serve (like with the agency and stewardship theories). If this is not the case, all that is left is chaos, as the director is unable to juggle all the demands placed upon them. If the only purpose is to accrue capital, those governing the corporation know what steps they should take¹⁷², but when this is no longer the case, and since there is no real “hierarchy” of these interests, the director will struggle and ultimately be unable to “do the right thing”¹⁷³.

As for what consequences we can see in practice when utilizing the stakeholder theory, there is no reliable hard data on this matter¹⁷⁴. Therefore, it is impossible to state if this doctrine is “correct” or “incorrect” and, therefore, it is likely to be a matter of academic discussion for years to come¹⁷⁵.

3.4.2 Parties Involved in the Stakeholder Theory

A major dilemma related to the stakeholder theory is the issue of defining the “stakeholder” itself¹⁷⁶. It is often stated to mean “any individual, who can influence the actions of the company or any individual, upon whom the actions of the company can have an influence”¹⁷⁷. Alternatively, it has been defined as “any individual, who has a vested interest in the life and work of the company”¹⁷⁸. Additionally, academic literature does contain proposals regarding how a hierarchy of the stakeholders can be created, but there is no real consensus there¹⁷⁹.

Even if there was no controversy with defining the primary term of the doctrine, the issue of its proponents’ failure to provide an adequate agreement regarding the hierarchy of stakeholders would still be a major issue. There is no agreement even on whether one stake can be considered to be superior to the other. Additionally, it is all but impossible to state whether one or another entity can be considered a “stakeholder”, which is directly tied to the nature of the theory at hand. For instance, a shareholder, a director or an employee are always considered to be stakeholders, but there is no agreement whether, say, the consumer or the state itself can be considered to be stakeholders. There is no settled practice on this matter¹⁸⁰. Therefore, the utilization of the stakeholder theory is fraught with a number of practical dilemmas.

ence, 15.3., 2004, 370-371.

¹⁶⁸ *Mitchell R.K., Agle B.R., Wood D.J.*, Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts, *The Academy of Management Review*, 22.4., 1997, 853-886.

¹⁶⁹ *Smith S.S.*, Integrated Reporting, Corporate Governance, and the Future of the Accounting Function, *International Journal of Business and Social Science*, 5.10., 2014, 58-63.

¹⁷⁰ *Carroll A.B., Shabana K.M.*, The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice, *International Journal of Management Reviews*, 12.4., 2010, 85-105.

¹⁷¹ *Freeman R.E., Wicks A.C., Parmar B.*, Stakeholder Theory and The Corporate Objective Revisited, *Organization Science*, 15.3., 2004, 364-369.

¹⁷² *Hitt M., Freeman E., Harrison J.*, *Handbook of Strategic Management*, Oxford, Blackwell Publishing, 2001.

¹⁷³ *Jensen M.C.*, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, *Business Ethics Quarterly*, 12.2., 2002, 235-256.

¹⁷⁴ *Чернышев М.А., Тяглое С.Г.*, *Теория Организации*, Ростов-на-Дону, Издательство Феникс, 2008.

¹⁷⁵ *Hitt M., Freeman E., Harrison J.*, *Handbook of Strategic Management*, Oxford, Blackwell Publishing, 2001.

¹⁷⁶ *Lau J.W.C.*, Enriching Stakeholder Theory: Student Identity of Higher Education, *American Journal of Industrial and Business Management*, 4, 2014, 762-766.

¹⁷⁷ *Kaeb C.*, Putting the “Corporate” Back into Corporate Personhood, *Northwestern Journal of International Law & Business*, 35.3., 2015, 591-653.

¹⁷⁸ *Kakabadze N.K., Rozuel C., Lee-Davies L.*, Corporate Social Responsibility and Stakeholder Approach: A Conceptual Review, *International Journal of Business Governance and Ethics*, 1.4., 2005, 277-302.

¹⁷⁹ *Alves E.R., Gomes E.R., Corsini L.F.*, The Characteristics of Power, Legitimacy and Urgency of Stakeholders and the actions of Corporate Social Responsibility of Companies, *Asian Journal of Business and Management Sciences*, 3.7., 2014, 34-46.

¹⁸⁰ *Hitt M., Freeman E., Harrison J.*, *Handbook of Strategic Management*, Oxford, Blackwell Publishing, 2001.

3.4.3 Summary of the Stakeholder Theory

In light of the aforesaid, it becomes clear that there are no settled approaches regarding the stakeholder theory. Even the central definition thereof is not agreed upon. This means that since there is no stability, its usage would be a truly great risk. As for its primary characteristics, in accordance with the discussions above, they can be summarized as follows:

1. The stakeholder theory postulates that the purpose of the director and the company at large is not to maximize their value, but, instead, to care for the well-being of all those who have a stake in the company.
2. Corporate governance has not only economic, but also moral and social dimensions and it should be conducted in accordance with all these values.
3. The definition of the term “stakeholder” is quite wide and it should be applied to different individuals based on their specific circumstances, without having a premade recipe.

4. Secondary Theories of Corporate Governance

4.1. The General Characteristics of the Secondary Theories

The secondary theories of corporate governance differ from their primary counterparts in that they have a much narrower view of the matters related to the governing of the company¹⁸¹. They are focused on specific matters and, therefore, do not offer a wide analysis like, for instance, the agency theory¹⁸². This results in the secondary theories being vastly less used in academic literature as well as in practice¹⁸³.

Additionally, it should also be noted that while the primary theories are opposed to each other and using more than one of them is all but impossible, the situation is quite different with the secondary theories. In reality, using two or more secondary theories without losing hold of their essence is quite possible, which stems from the narrow scope of these doctrines. They rarely oppose each other and one could easily utilize several of them at once¹⁸⁴.

Due to the narrow scope and purpose of the secondary theories, their names directly stem from the functions that they are supposed to fulfill. Therefore, their names should be directly translated as well, something that is seen in foreign academic literature¹⁸⁵¹⁸⁶. The research at hand utilizes such an approach, translating the titles of the secondary theories verbatim, without losing sight of their core ideas.

4.2 The Resource Dependency Theory

The subject matter of the resource dependency theory is the role and function of the director in the everyday life of the company¹⁸⁷. This doctrine states that the company depends on having relevant resources for any actions it

¹⁸¹ *Zerk J.A.*, *Multinationals and Corporate Social Responsibility: Limitations and Opportunities in International Law*, New York, Cambridge University Press, 2006.

¹⁸² *Либман В.А.*, Теоретические Аспекты Агентской Проблемы в Корпораций, Вестник, СПбГУ, 8.1., 2005, 123-140.

¹⁸³ *Бакунова Н.В., Мухаровский Н.В.*, Трансформация Корпоративного Управления в Условиях Рыночных Отношений, Вестник Омского университета, 2, 2011, 80-84.

¹⁸⁴ *Hitt M., Freeman E., Harrison J.*, *Handbook of Strategic Management*, Oxford, Blackwell Publishing, 2001.

¹⁸⁵ *Basle M., Delorme R., Lemoigne J.L., Paulre B.*, *Approches Évolutionnistes De La Firme Et De L'industrie*, Paris, Harmattan, 1999.

¹⁸⁶ *Weibel A.*, *Kooperation in Strategischen Wissensnetzwerken, Vertrauen und Kontrolle zur Losung des Sozialen Dilemmas*, Wiesbaden, Mohr Siebeck, 2004.

¹⁸⁷ *Htay S.N.N., Salman S.A.*, Transaction Cost Theory, Political Theory and Resource Dependency Theory in The Light of Unconventional Aspect, IOSR Journal of Humanities and Social Science, 12.5., 2013, 89-96.

wants to undertake. Therefore, the function of the director is to ensure that all these resources are made available to the company¹⁸⁸.

The Resource dependency theory stipulates, that the company requires a huge number of such resources, the existence of which is essential to its success. This includes capital, human resources and, additionally, other individuals, the contact with whom may facilitate the company to obtain what it needs¹⁸⁹.

The resource dependency theory states that it is the directors' primary function, to obtain these badly needed resources and, at the same time, it emphasizes that no one else is capable of doing so¹⁹⁰. The doctrine at hand emphasize the need for the directors to form personal relations with "important" individuals, as, in this manner, the director may achieve a leg-up on the competitors for the company, which would go a long way in supporting the success of the business entity¹⁹¹.

It should not be forgotten, that while the theory at hand postulates the obtaining of the needed resources to be the primary function of the director, but this does not mean that the director no longer has other duties to the company¹⁹². They have the obligation to support their corporation in every way possible and that is not limited to simply getting the resources

4.3 The Transaction Cost Theory

The transaction cost theory has become established as a part of corporate governance as a result of the influence of economic theories¹⁹³. It sees any and all companies as a web of contracts and transactions. The higher this cost becomes, the less effective the management of the company should be considered to be. Therefore, it is the primary function of the director to make certain that the cost of these transactions is as low as possible, thereby enhancing the efficiency of the company's governance¹⁹⁴.

The theory at hand discusses a number of relationships, the cost of which is needed to be lowered by the director. It contains, for example, the matters related to the oversight of the directors as well. The transaction cost theory considers such control mechanisms to be unnecessary and, therefore, postulates that the company's resources should not be wasted in order to check the reliability and trustworthiness of those who are supposed to be leading it. It more so rules out the creation of a permanent entity, the sole function of which would be to oversee the directors¹⁹⁵. Instead, the transaction cost theory demands that only the directors, who can be trusted, be appointed, so that there is no need to control them¹⁹⁶. The theory at hand recognizes the risks associated with such an approach, but considers them to be worth taking, as reducing the costs is considered to be of greater importance. As for the risks, they are placed squarely on the shareholders. Therefore, if a director is appointed and they proceed to act against the best interests of the company, this is considered to be the "fault" of the

¹⁸⁸ *Hung H.*, A Typology of the Theories of the Roles of Governing Boards, *Scholarly Research and Theory Papers*, 6.2., 1998, 101-111.

¹⁸⁹ *Yussoff W., Alhaji I.*, Insight of Corporate Governance Theories, *Journal of Business & Management*, 1.1., 2012, 52-63.

¹⁹⁰ *Van Ness R., Miessing P., Kang J.*, Understanding Governance and Corporate Boards: Is Theory a Problem, *European Journal of Management*, 7.9., 2009, 186-199.

¹⁹¹ *Pfeffer J.*, Merger as a Response to Organizational Interdependence, *Administrative Science Quarterly*, 17, 1972, 218-228.

¹⁹² *Htay S.N.N., Salman S.A.*, Transaction Cost Theory, Political Theory and Resource Dependency Theory in The Light of Unconventional Aspect, *IOSR Journal of Humanities and Social Science*, 12.5., 2013, 89-96.

¹⁹³ *Geyskens I., Steenkamp J.E.M., Kumar N.*, Make, Buy, or Ally: A Transaction Cost Theory Meta-Analysis, *Academy of Management Journal*, 49.3., 2006, 519-543.

¹⁹⁴ *Zajac E.J., Olsen C.P.*, From Transaction Cost to Transactional Value Analysis: Implications for the Study of Interorganizational Strategies, *Journal of Management Studies*, 30.1., 1993, 131-145.

¹⁹⁵ *Coase R.H.*, The Nature of the Firm, *Economica*, 4.16., 1937, 386-405.

¹⁹⁶ *Hardt L.*, The History of Transaction Cost Economics and Its Recent Developments, *Erasmus Journal for Philosophy and Economics*, 2.1., 2009, 29-51.

shareholders, as they failed to appoint someone worth trusting and, therefore, it is the shareholders who should be found accountable¹⁹⁷.

One other thing that should be emphasized, is that unnecessary risks should not be undertaken, as this can easily lead to the suffering of the company. In the end, the transaction cost theory can be summarized as a doctrine, which states that value maximization for the shareholders is the primary purpose of corporate governance and in this pursuit, undue risks should not be taken, but the costs should be reduced considerably, something that, as per the theory at hand, would lead to the occurrence of the favorable results for the company¹⁹⁸.

4.4 The Political Theory

The political theory of corporate governance states, that a major role in the day-to-day life of the company is played by the internal politics of the corporation¹⁹⁹. It considers all other theories to be naïve, as they deliberate on the optimal decisions that must be made by the parties that be, without analyzing the political situations that may lead to certain actions, such as the internal structure of the company and the people in it²⁰⁰. This theory, just like the agency theory, postulates that the egotistical interests of the directors are much more important to them than those of the company or its shareholders. Therefore, the political position of the director becomes of paramount importance²⁰¹.

The political theory can be summarized as follows: The director, usually, is appointed by the shareholders and is responsible to them as well. The power that the director possesses stems from the shareholders. Therefore, the most important thing the director must do, at least in their own mind, is to sustain the good grace of the shareholders in order to rule out their own power being diminished or lost completely²⁰².

The political theory emphasizes the need for the directors to be seen as politicians. They are prepared to utilize the company's resources in order to protect their own position within the internal hierarchy and will take any steps that would strengthen this position, even if they may be detrimental to the company itself or the shareholders thereof²⁰³. This may include providing incorrect information, as well as intentionally acting otherwise in a manner that would harm the company or its stakeholders²⁰⁴.

Of course, in some cases, the director will attempt to sway the graces of the shareholders by acting in a way that is beneficial to the company²⁰⁵. On such occasions, there are no issues, but, unfortunately, there are often different situations in practice. One example would be the often seen practice of the director requiring to have the shareholders on their side and, therefore, issuing dividends at a point in the life of a company when such an action would severely harm the interests of the corporation²⁰⁶.

¹⁹⁷ *Williamson O.E.*, *The Mechanisms of Governance*, New York, Macmillan Free Press, 1998.

¹⁹⁸ *Htay S.N.N., Salman S.A.*, *Transaction Cost Theory, Political Theory and Resource Dependency Theory in The Light of Unconventional Aspect*, IOSR Journal of Humanities and Social Science, 12.5., 2013, 89-96.

¹⁹⁹ *Abdullah H., Valentine B.*, *Fundamental and Ethics Theories of Corporate Governance*, Middle Eastern Finance and Economics, 4, 2009, 88-96.

²⁰⁰ *Muller H.M., Warneryd K.*, *Inside Versus Outside Ownership: A Political Theory of the Firm*, RAND Journal of Economics, 32.3., 2001, 527-541.

²⁰¹ *Gourevitch P.A.*, *The Politics of Corporate Governance Regulation*, The Yale Law Journal, 112, 2003, 1829-1880.

²⁰² *Roe M.J.*, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton, Princeton University Press, 1994.

²⁰³ *Fadun O.S.*, *Corporate Governance and Insurance Company Growth: Challenges and Opportunities*, International Journal of Academic Research in Economics and Management Sciences, 2.1., 2013, 286-305.

²⁰⁴ *Muller H.M., Warneryd K.*, *Inside Versus Outside Ownership: A Political Theory of the Firm*, RAND Journal of Economics, 32.3., 2001, 527-541.

²⁰⁵ *Roe M.J.*, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton, Princeton University Press, 1994.

²⁰⁶ *Nasieku T., Olubunmi E.M., Togun O.R.*, *Corporate Governance And firm's Earnings Quality*, Economics and Finance Review, 3.12., 2014, 1-10.

It should be emphasized that, in accordance with the political theory, the discussed problems arise in both large and small companies. Therefore, the need to mitigate this threat is especially important. Unfortunately, the theory at hand offers no specific, concrete proposals which would help solve the presented issues. One idea is to create a supervisory entity that would be wholly independent of the shareholders and the directors. This stems from the opinion that the shareholders are unlikely to see any issues with the actions that benefit them, while this entity would in no way be able to benefit from the actions of the director, something that would guarantee its members' impartiality. This would help ensure that the directors serve the company, instead of protecting their own interests or, alternatively, telling the shareholders only the things they want to hear²⁰⁷.

4.5 The Legitimacy Theory

The central idea of the legitimacy theory is that in order for the company to continue its existence, the steps taken by it should be seen as "legitimate". This means that it must only take steps which would be considered acceptable by the society at large²⁰⁸. At the same time, the legitimacy theory states that the corporation is not obliged to do more than the bare minimum which would be enough for it to not cause an antagonistic attitude. It should not be hated, but should also do nothing more²⁰⁹.

The positions of the legitimacy theory stem from the fact that, according to it, the final authority, the most important entity that supervises the company is not the shareholders, but the society at large, the people in general²¹⁰. At the same time, the directors do not have a duty to care for the interests of the society or to think about their livelihood. The legitimacy theory merely demands that the company have a positive reputation in the eyes of people and it does not care whether the corporation actually deserves such good graces, or what actions they undertake to obtain such a reputation²¹¹.

In light of the aforesaid, the legitimacy theory can be summarized as follows: The director has a duty to make certain that the society has a positive view of the company and its reputation, but it must obtain such a result by spending as little resources as possible. What way is used to create this reputation, is of no importance to the theory at hand.

4.6 The Social Contract Theory

The social contract theory, just like the legitimacy theory, is focused on making sure that the actions of the company are perceived as "legitimate", but the difference is that here, the most important result is not the reputation, but the result of such legitimate actions²¹². It considers that all actions related to the economy need to be based on two fundamental aspects – a social contract and the moral imperatives²¹³.

A social contract is the model of the society, which has been widely used since the eighteenth century and according to which, when living and acting in the society at large, people (and legal entities) voluntarily give

²⁰⁷ *Roe M.J.*, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance. Princeton, Princeton University Press, 1994.

²⁰⁸ *Omran M.A.*, Theoretical Perspectives on Corporate Social Responsibility Disclosure: A Critical Review, *International Journal of Accounting and Financial Reporting*, 5.2., 2015, 38-55.

²⁰⁹ *Bather A., Tucker R.*, Legitimacy Theory and a Compliance Analysis of Tesco's 2008 Business Review, *International Review of Business Research Papers*, 7.2., 2011, 137-156.

²¹⁰ *Yussoff W., Alhaji I.*, Insight of Corporate Governance Theories, *Journal of Business & Management*, 1.1., 2012, 52-63.

²¹¹ *Aziz N.A.A., Manab N.A., Othman S.N.*, Exploring the Perspectives of Corporate Governance and Theories on Sustainability Risk Management (SRM), *Asian Economic and Financial Review*, 5.10., 2015, 1148-1158.

²¹² *Yussoff W., Alhaji I.*, Insight of Corporate Governance Theories, *Journal of Business & Management*, 1.1., 2012, 52-63.

²¹³ *Othman Z., Rahman R.A.*, Understanding Corporate Governance from a Social Constructionist Perspective, *International Journal of Humanities and Social Science*, 1.2., 2011, 123-127.

up certain rights and freedoms in exchange for a guarantee that other rights and freedoms are protected²¹⁴. The social contract theory of corporate governance uses this model as well and states, that just like the society is obliged to protect the company (via the rules and regulations formulated and enforced by the state), so the corporation has a duty to care for the society itself²¹⁵.

In the end, it should be noted, that even under this theory, the primary duty of the directors is the protection of the company's interests (in which it differs from the stakeholder theory). At the same time, the director is obliged to act in protection of these values in a manner that is not amoral and the company is able to "repay the debt" to the society. This should occur in a way that the company takes social responsibility upon itself and supports the development of the economic climate²¹⁶.

4.7. The Enlightened Stakeholder Theory

The enlightened stakeholder theory can be, in a way, considered to be a synthesis of the agency theory and the stakeholder theory²¹⁷. Its central idea is that, according to it, the success of the company can be determined by its monetary value²¹⁸. However, it also does not reject the statement of values of the stakeholder theory and considers the primary function of the company to protect the interests of all those affecting it and affected by it²¹⁹.

This theory was created partly as a response to the negative opinions regarding the stakeholder theory, namely the idea that it lacks a central target towards which the director should strive, making them easily confused as to what route of action they should pursue²²⁰. This issue is remedied by the enlightened stakeholder theory, which provides a specific barometer of the company's success. It states, that the "goodness" of the company's actions can be determined by how they will impact the corporation's value in the long term²²¹. Therefore, it is the director's duty to ensure that the value of the company's shares (and, by extension, the company itself) always rises with time.

A positive side of the enlightened stakeholder theory is that it is capable of somewhat satisfying the supporters of all three primary theories of corporate governance. It is acceptable to the proponents of the agency and stewardship theories, as it emphasizes value maximization and the enrichment of the shareholders by means of making the company as valuable as possible, which would be great to the corporation itself as well²²². While it underscores the long-term goals, but this should not be misconstrued to diminish its value²²³. At the same time, it agrees with the stakeholder theory and considers the moral aspects of corporate governance. It stipulates, that the duties of the directors include caring for the interests of all the stakeholders, not just the shareholders or the

²¹⁴ Mouritz T., Comparing the Social Contracts of Hobbes and Locke, *The Western Australian Jurist*, 1, 2010, 123-127.

²¹⁵ Moir L., What Do We Mean by Corporate Social Responsibility? *The Journal of Corporate Governance*, 1.2., 2001, 16-22.

²¹⁶ Sacconi L., Corporate Social Responsibility and Corporate Governance, *EconomEtica*, 38, 2012, 1-42.

²¹⁷ Jensen M.C., Value Maximization, Stakeholder Theory, and the Corporate Objective Function, *Business Ethics Quarterly*, 12.2., 2002, 235-256.

²¹⁸ Tullberg J., Stakeholder Theory: Some Revisionist Suggestions, *The Journal of Socio-Economics*, 42, 2013, 127-135.

²¹⁹ Branco M.C., Rodrigues L.L., Positioning Stakeholder Theory within the Debate on Corporate Social Responsibility, *Electronic Journal of Business Ethics and Organization Studies*, 12.1., 2007, 5-15.

²²⁰ Чернышев М.А., Тяглое С.Г., Теория Организации, Ростов-на-Дону, Издательство Феникс, 2008.

²²¹ Agyemang O.S., Aboagye E., Frimpong J., Where Does the Relevance of Corporate Governance Lie? *Business and Economics Journal*, 5.3., 2014, 1-4.

²²² Babatunde M.A., Olaniran O., The Effects of Internal and External Mechanism on Governance and Performance of Corporate Firms in Nigeria, *Corporate Ownership & Control*, 7.2., 2009, 330-344.

²²³ Jensen M.C., Value Maximization, Stakeholder Theory, and the Corporate Objective Function, *Business Ethics Quarterly*, 12.2., 2002, 235-256.

corporation²²⁴. It states, that the best way for the interests of the stakeholders to be preserved is for the director to make sure that the company is successful in the long run, which would enhance its value for all involved²²⁵. This approach ties the interests of the company, as well as its shareholders and the stakeholders to each other, thereby all but ruling out meaningful conflict among them, which, as per the present theory, is a guarantee that healthy and efficient corporate governance will be ensured.

The enlightened stakeholder theory is one of the newest concepts in corporate governance. Despite this, it has found considerable support already and, as some believe, can be considered to be in serious contention for being considered the fourth primary theory²²⁶. However, it should be noted, that there is quite a large group of opponents of the enlightened stakeholder theory in academic literature, who consider it to be unacceptable in an economic sense and believe that it is nowhere near optimal²²⁷. This, coupled with the novelty of the theory and certain gaps in its approaches, means that until it is effectively tested in practice, it is all but impossible to definitively support or oppose it. Therefore, there is no real consensus regarding it in academic literature.

4.8 The Ethics Theories

Unlike the theories discussed above, the ethics theories of corporate governance cannot be considered a single, specific theory. Essentially, instead of this, there is an amalgamation of several smaller theories, which have only one thing in common – that they are based in ethics – hence the name²²⁸.

These theories take several approaches to corporate governance. One of them, the “business-ethics theory” postulates, that since the role of business within the society is ever expanding, that means that the companies have a duty to enhance the duties they are willing to undertake in the life of the society²²⁹. The “moral values theory” states, that such a duty stems from the fact that all people are obliged to adhere to ethical norms and this includes groups of people as well (which includes companies)²³⁰. Finally, the postmodern moral theory states that the achievement of the aims that are determined by an individual’s ethics is the need that all people have, therefore, acting in such a manner would be preferable to the company as well, something that would enhance its effectiveness²³¹.

One thing that needs to be noted, is that due to the varied nature of the ethics theories, their influence upon corporate law is quite miniscule. This leads to the situation that, when one wants to consider the moral aspects of corporate governance, instead of ethics theories, the stakeholder theory is used instead.

²²⁴ *Pour B.S., Nazari K., Emami M.*, Corporate Social Responsibility: A Literature Review, *African Journal of Business Management*, 8.7., 2014, 228-234.

²²⁵ *Obeten O.I., Ocheni S.*, Empirical Study of the Impact of Corporate Governance on The Performance of Financial Institutions in Nigeria, *Journal of Good Governance and Sustainable Development in Africa*, 2.2., 2014, 57-73.

²²⁶ *Branco M.C., Rodrigues L.L.*, Positioning Stakeholder Theory within the Debate on Corporate Social Responsibility *Electronic Journal of Business Ethics and Organization Studies*, 12.1., 2007, 5-15.

²²⁷ *Babatunde M.A., Olaniran O.*, The Effects of Internal and External Mechanism on Governance and Performance of Corporate Firms in Nigeria, *Corporate Ownership & Control*, 7.2., 2009, 330-344.

²²⁸ *Badiyani B.M.*, Corporate Governance: Ethical Issues and Popular Theories, *International Journal of Research in Economics & Social Sciences*, 3.2., 2013, 15-19.

²²⁹ *Crane A., Matten D.*, *Business Ethics*, 2nd ed., London, Oxford University Press, 2007.

²³⁰ *Annas J.*, *Virtue Ethics and Social Psychology A Priori*, 2, 2003, 20-34.

²³¹ *Badiyani B.M.*, Corporate Governance: Ethical Issues and Popular Theories, *International Journal of Research in Economics & Social Sciences*, 3.2., 2013, 15-19.

5. Corporate Governance Theories and Law

The paragraphs of the research at hand provided above discussed both the primary as well as the secondary theories of corporate governance. This paragraph summarizes the legislative approaches characteristic of the laws that are drafted in accordance with the demands of specific theories. After this has concluded, a critical evaluation shall be made of these approaches when comparing them with the Georgian corporate law. After this, if needed, recommendations will be provided.

5.1 Laws Created in Accordance with the Corporate Governance Theories

The relevant paragraphs and sub-paragraphs of this research have provided the primary characteristics of all the discussed theories of corporate governance. Therefore, at this stage, it is logical to analyze them and summarize the general principles that are usually seen when the laws are based on these specific theories. It is the position taken by this research, that such principles are as follows:

- **Agency theory** – The only purpose of the director is to maximize the value for the shareholders, the shareholders utilize the mechanisms to control and oversee the director, the director's pay is tied to his success and all responsibility for undue risks rests with them as well.
- **Stewardship theory** – The only purpose of the director is to maximize the value for the company itself, the shareholders are not involved in the running of the company and they do not supervise the directors (not even possessing such mechanisms), the responsibility for risks does not rest with the director.
- **Stakeholder theory** – The purpose of the director, as well as the company itself, is to care for the interests of all parties involved with the running of the company, stakeholders can participate in corporate governance, the society has social responsibilities and is not focused solely on value maximization, an emphasis is put on moral values.
- **Resource dependency theory** – The purpose of the director is defined as obtaining a number of resources for the company.
- **Transaction cost theory** – The purpose of the director is to lower the cost of transactions for the company. All inefficient mechanisms are annulled.
- **Political theory** – The director is supervised in a way that is entirely independent of the shareholders, so that it is possible to ensure their effectiveness.
- **Legitimacy theory** – The company is obliged to abide by the societal norms, but only so far that it is needed for its reputation to remain at least somewhat positive.
- **Social contract theory** – The company has the obligation to care for the society, as the society is caring for it in the limits of the social contract entered into.
- **Enlightened stakeholder theory** – The director must care for the shareholders and the company, as well as the stakeholders at large. This needs to occur by ensuring the long-term success of the company. The emphasis is put on the future of the company.
- **Ethics theories** – The purpose of the company is to act in a way that complies with ethical and moral norms.

As it has already been discussed, the secondary theories of corporate governance are quite limited in scope, which leads to them being far less utilized in practice by the legislator. Therefore, it is the primary theories which usually form the basis of national laws.

5.2 Corporate Governance Theories and the Georgian Legislation

As it has already been stated within this research, a big part of Georgian legislation has been created by the means of legal transplantation. This fact means that it is quite likely that the Georgian corporate law framework has been drafted without a deep understanding of the theories underlining the topic at hand. If there is no real, concrete approach visible in the current laws that would be the proof of such a lack of understanding of the theoretical basis.

The paragraph at hand presents the primary source of Georgian corporate law – the Law on Entrepreneurs. This analysis is conducted so that it becomes possible to determine if there is a single, consolidated approach in the legislative framework regarding the theories of corporate governance and which ones, if any, can be seen to influence the stated legislative document.

First of all, it should be noted that the Law on Entrepreneurs is quite short and provides a rather laconic legislative framework. Therefore, there are no regulations provided regarding a number of matters, which are quite important in regards of the corporate governance theories. Despite this, however, there is still a possibility of seeing the style characterizing certain theories within the text of the law.

The Georgian Law on Entrepreneurs never even mentions the duties of the companies towards the third parties. As for the rights to govern the company, they are not granted to anyone except the shareholders and those appointed by them. Additionally, not a single rule is provided dealing with ethics or morals. Therefore, it is quite easy to state that the existing law rejects out of hand five out of ten theories of corporate governance – the stakeholder theory, the legitimacy theory, the social contract theory, the enlightened stakeholder theory and the ethics theories.

As for the three remaining secondary theories, due to their limited scope, in order to be able to say that they are utilized within the national law, their usage should be clearly visible. This is most certainly not the case, as there is not a single reference to obtaining resources or lowering the cost of transactions. Therefore, the transaction cost theory and the resource dependency theory are also definitively rejected.

The final secondary theory of corporate governance – the political theory, can be considered to be possibly influencing the legislation of Georgia. Article 55.21 of the Law on Entrepreneurs stated, that if a company is the “responsible entity”, or a corporation, the shares of which are being traded on a stock exchange, needs to have at least one supervisory board member, who is not a shareholder or an employee of the company, or otherwise being involved in its work. This means that on at least one occasion, the law demands for a person in a supervisory role to be wholly independent²³², which is in line with the demands of the political theory.

The Georgian Law on the Securities Market defines the “responsible entity” to mean a company established in accordance with Georgian laws, which has issued publicly traded securities²³³. As for the supervisory board, it is regulated by the Law on Entrepreneurs and basically can be considered to be an entity which is to control and oversee the directors²³⁴. Therefore the law clearly demands for a person in a supervisory role to be wholly independent, which is in line with the demands of the political theory. Despite this, one should keep in mind that this applies to only one member of the supervisory board, which can be composed of at least three and no more than 21 individuals²³⁵. As it has already been stated, the political theory makes it compulsory for the supervisory bodies to be entirely consisting of independent individuals, while having 1 out of 21 people be not tied to the management of the company cannot be considered to be enough to fulfill this requirement. Additionally, there is no demand for this board to make unanimous decisions on anything. Therefore, this makes the independent member quite impotent. Therefore, it can be said, that while there is a rule that is similar to the one demanded by

²³² Georgian Law on Entrepreneurs, 1994, Article 55, Sub-paragraph 21.

²³³ Georgian Law on the Securities Market, 1998, Article 9.

²³⁴ Georgian Law on Entrepreneurs, 1994, Article 55.

²³⁵ Georgian Law on Entrepreneurs, 1994, Article 55, Sub-paragraph 1.

the political theory, the influence of this doctrine upon Georgian legislation is clearly too limited and it cannot be considered to be an instrument that has a real influence on the existing framework of corporate law.

Due to all the aforesaid, there are only two remaining theories, which can be considered to possibly be the basis of the corporate laws of Georgia. These are the stewardship theory and the agency theory.

On one side, the Georgian law definitely provides a number of rules, which can be assumed to be influenced by the agency theory. One example of this would be the entity known as the supervisory board, which is supposed to oversee the directors and participates in the governance of the company. This is in line with the agency theory and directly opposes the stewardship theory, which considers such instruments to be a pointless waste of resources. Additionally, the Law on Entrepreneurs grants rather wide governance rights to the shareholders²³⁶²³⁷, which is also opposed to the ideals espoused by the stewardship theory, which state that the shareholders should assume a passive role and not interfere with the running of the company. One additional rule put forth by the Law on Entrepreneurs is the idea that if a company has the right to demand something from a third party but fails to do so, any shareholder gains the right to exercise this right themselves, on behalf of the company²³⁸.

Notwithstanding the above, the Law on Entrepreneurs also provides rules, which oppose the ideas of the agency theory. For instance, the law does not refer to the payment of the directors. This matter being ignored goes against the agency theory, but is fully compliant with the stewardship theory. Additionally, unless the corporation is incorporated as a Joint Stock Company and has at least 100 shareholders, it is not obliged to create a supervisory board²³⁹, which is also not in line with the agency theory.

Finally, the best argument in favor of the stewardship theory is that the Law on Entrepreneurs directly states the directors to be accountable before the company and not the accountants. More so, there is a stipulation, that the director must act “in belief, that the actions undertaken by them are favorable to the company” and that “the director cannot claim to not be responsible for their actions on the basis on acting in accordance with the wishes and decisions of the shareholders”²⁴⁰. Therefore, when there is a conflict of interest among the company and the shareholders, the Georgian law favors the company, which complies with the stewardship theory.

As it becomes clear from the aforesaid, there is no accepted approach regarding the corporate governance theories in Georgian law. There is some influence of the agency and stewardship theories visible, the political theory also having a minor role, but there is most definitely a lack of a single accepted consensus and all we have is an amalgam of the three theories. This stems from the fact that the law is clearly created as a result of legal transplantation. Therefore, the law has been drafted without its fundamental theories being understood. This can easily become problematic and it would be desirable for the Law on Entrepreneurs to be reformed in a way that makes it clear, as to which theory is preferred by the legislator.

5.3 Reform of Georgian Corporate Laws and Recommendations

The Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part states, that Georgia is obliged to approximate its legislation with that of the European Union. One of the fields where this obligation exists, is that of corporate law, where Georgia needs to transpose the norms set forth in 8 of the EU directives²⁴¹.

²³⁶ Georgian Law on Entrepreneurs, 1994, Article 91.

²³⁷ Georgian Law on Entrepreneurs, 1994, Article 54.

²³⁸ Georgian Law on Entrepreneurs, 1994, Article 53.

²³⁹ Georgian Law on Entrepreneurs, 1994, Article 55, Sub-paragraph 1.

²⁴⁰ Georgian Law on Entrepreneurs, 1994, Article 9, Sub-paragraph 6.

²⁴¹ The Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part, 2014, Annex XXVIII.

In order for these rules to be transposed into Georgian legislation, work has been started on a new Law on Entrepreneurs. For the mistakes of the past not to be repeated, legal transplantation must no longer be the primary source of the new legislative framework. The new law should be created in a manner that understands the theoretical framework, up to and including the primary as well as the secondary theories of corporate governance. As a result of the comprehension of the theoretical basis, specific approaches and methods need to be created, so that the project of the new law is drafted in compliance with this approach, resulting in a law that has a solid theoretical base.

This can be considered somewhat problematic, as Georgia has an obligation to transpose EU laws into the national legislation. This factor, of course, bears keeping in mind, however, what should be emphasized is that the directives of the EU give quite a lot of leeway, allowing the legislator the chance to maneuver and draft a law in compliance with the theoretical basis that would considerably enhance the resultant act²⁴². Therefore, there is a possibility of doing so, meaning that this is a chance that needs to be used.

The approach adopted by the research at hand is, that the new Law on Entrepreneurs must be drafted so that the position of the state in regards of the theories of corporate governance is well established. This research does not identify the “best” theory, but concludes that it is imperative for the state to be staunch in its support of one of the theories. This would give the law a strong backbone, which would undoubtedly be a positive development.

6. Conclusion

The research at hand has stated, that the corporate governance theories are an important instrument for the determination of the primary principles of the corporate law of the nation. They have, essentially, not been used in Georgia and, more so, there is all but no academic literature available on this matter, which is a significant issue. This problem must be remedied, something that can be done only by understanding the theories of corporate governance well, which would be followed by the state defining its approach and amending the laws in accordance with it.

The purpose of the present research was to discuss the theories of corporate governance, to compare the positions supported by the with the national legislative framework and to provide recommendations regarding the outcome of this comparison. This function has been completed and, based on it, at interested party has the chance to understand the corporate governance theories, as well as their functions, demands and importance of a single, unified approach.

In case that the recommendations provided by this research are heeded, this would be a positive development for the corporate laws of Georgia. Alternatively, even if the legislator ignores it, a text deeply analyzing and scrutinizing the corporate governance theories is an addition to Georgian academic literature, something that was not done before. Therefore, hopefully, this research will have played a small role in the development of corporate law in Georgia, as well as the academic literature regarding it.

²⁴² *Volaard H., Martinsen D.S., Bounded Rationality in Transposition Processes: The Case of the European Patients’ Rights Directive, West European Politics, 37.4., 2014, 711-731.*

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