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Abstract
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Keywords
corporate stakeholders, employees, stakeholder interests, shareholders, employee share ownership plan, ESOP

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DO ESOPS STRENGTHEN EMPLOYEE STAKEHOLDER INTERESTS?

By Adam Reynolds*

The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.

*  B Bus (Acc), B App Sc (Comp), CPA, MACS.
1  Hutton v West Cork Rly Co (1883) 23 Ch D 654, 673. This probably was adapted from William Shakespeare, Twelfth Night, Act 2, Scene 3: ‘Dost thou think, because thou art virtuous, there shall be no more cakes and ale?’
3  Ibid.
4  See comments by President Bill Clinton and Prime Minister Tony Blair cited in ‘Shareholder Values’ (1996), 338 (7952) The Economist 13.
6  Corfield, ibid 235.
In the first section of this paper, I will discuss generally the ‘stakeholder’ approach to corporations. I will then focus on employees as a distinct group of stakeholders, and establish that under Australian law, employees as stakeholders have less corporate ‘muscle’ than in overseas jurisdictions. Based on this, I will then discuss whether employees as shareholders can promote their claims within the corporate hierarchy, either as members of an employee share ownership plan (ESOP) or as independent investors.

**Stakeholders**

**The Modern Debate**

The modern debate revolving around the conflict between a company’s obligations to its shareholders and to its stakeholders traces its origins to the 1930s in the pages of the *Harvard Law Review*. Professor AA Berle, Jr proposed a thesis that ‘all powers granted...to the management of a corporation...are necessarily and at all times exercisable only for the ratable benefit of all of the shareholders’. In opposition to this, Professor EM Dodd, Jr argued that although *Dodge v Ford Motor Co* clearly supported this proposition from a legal perspective, the developing feeling was that capitalism is worth saving but that it cannot permanently survive under modern conditions unless it treats the economic security of the worker as one of its obligations and is intelligently directed so as to attain that object.

Berle’s rejoinder highlighted that this was based on theoretical, and not practical, principles. However, some years later, he acknowledged that ‘social fact and judicial decisions’ had subsequently prevailed in support of Dodd’s viewpoint.

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10 (1919) 204 Mich 459, 170 NW 668. This case involved the rejection by Ford shareholders of profits being used to reduce car prices (a stakeholder benefit) in favour of increased dividends (a shareholder benefit).
11 EM Dodd, ‘For Whom are Corporate Managers Trustees?’ (1932) 45 Harvard Law Review 1145, 1147.
12 Ibid 1152.
DO ESOPS STRENGTHEN EMPLOYEE STAKEHOLDER INTERESTS?

The Primacy Spectrum

Although a discussion of stakeholder interests would appear to be bipolar in nature, it is actually a spectrum.

Figure 1 - Stakeholder Primacy Spectrum

At one end of the spectrum is a ‘pluralist’ view which mandates that a board should accommodate the needs of all parties that may be affected by its decisions, the shareholders being just one of these groups. At the other end of this spectrum is the proposition that a company, through its directors, should act to the exclusive benefit of its shareholders.\(^{15}\) Germany (with its two-tier co-determinative governance model)\(^ {16}\) and Japan (with its long-term worker orientation)\(^ {17}\) are often recognised for their leaning away from a pure shareholder focus. The stakeholder-shareholder debate has recently been criticised as ‘bogus’,\(^ {18}\) and it has been asserted that a more realistic perspective lies in between, where the concept of ‘enlightened shareholder value’ is used. This theory gives primacy, but not exclusivity, to the needs of shareholders, on the basis that the consideration of other constituents’ interests will lead to long term benefits for shareholders.\(^ {19}\)

It is very difficult to judge the success of the different perspectives. Pure shareholder interest satisfaction is measured in terms of long term shareholder returns; in contrast, stakeholder interest satisfaction cannot be measured in

\(^{15}\) See also Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995), 202-234 (arguing that shareholders are not the only group of stakeholders who are residual claimants in a company).

\(^{16}\) Corfield, above n 5, 232.

\(^{17}\) Corfield, ibid 235.


In addition, many stakeholder interests tend to overlap. In material, concrete terms.

**Employees as Stakeholders**

The potential enforcement of employee stakeholder interests could be manifested in two possible forms. Employees may seek to somehow enforce their stakeholder interests – this can be seen as a positive enforcement by employees of these interests. Alternatively, where employee stakeholder interests have been given precedence over the rights of other stakeholders – such as shareholders – those shareholders may seek to enforce their rights against employees. In this paper, I have termed this the negative enforcement by other stakeholders of their rights against employees. A review of comparative corporations law in the United Kingdom and United States highlights the fact that in the stakeholder primacy spectrum, Australian employees of corporations rate poorly.

**Positive Enforcement of Stakeholder Interests by Employees**

**United Kingdom**

The *Companies Act 1985 (UK)* states that ‘the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general, as well as the interests of its members.’ This duty is owed by directors ‘to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.’ The exact meaning of this section has not yet been tested in court. Two interpretations have been offered; the more radical suggests that a balancing of employee and shareholder interests is required. The conservative view suggests that employee interests must be considered but not subordinated to shareholder interests. Regardless, the beneficiaries of this stakeholder legislation have no *locus standi* to challenge directors’ decisions, and thus this is a very weak form of stakeholder protection. The ‘emptiness’ of this section is further exposed when the absence of suitable remedies is recognised. Current law reform in the UK recommends the retention and rewording of this

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20 Cook & Deakin, above n 5, 9.
21 Ibid 12.
22 *Companies Act 1985 (UK)* s 309(1).
23 *Companies Act 1985 (UK)* s 309(2).
Do ESOPS Strengthen Employee Stakeholder Interests?

provision: ‘the circumstances to which (a director) is to have regard…include…the company’s need to foster its business relationships, including those with its employees’. I would argue that this recommendation does little to strengthen the recognition of employee interests.

United States

About half of the States have enacted some form of stakeholder-oriented laws. These vary from the permissive – similar in nature to the Companies Act 1985 (UK) – to the mandatory. An example of the former is Pennsylvania, where the board may consider ‘the effects of any action upon…employees’. An example of the latter is Connecticut, where directors are required to consider (inter alia) ‘the interests of the corporation’s employees’.

Australia

Despite law reform recommendations, Australia currently has no employee-specific provisions in the Corporations Act, and as such, directors in Australia owe no duties directly to employee stakeholders. The legislative position is supported by empirical studies, where a majority (74%) of Australian directors rank shareholders well ahead of employees in priority of obligations.

I would argue that employees as stakeholders are better provided for under industrial relations laws. Alternatively, in line with the ‘nexus of contracts’ theory of corporations, they can, and do, enter into individual contracts with

29 15 PaCSA § 516(a) – note that this was the first non-constituency statute passed in the United States, in 1986. See also, eg, OH ST § 1701.59(E).
30 CT ST § 33-756(d).
31 Senate Standing Committee on Legal and Constitutional Affairs (the Cooney Committee), Company Directors’ Duties (1989), 84-90.
32 Sealy, above n 26, 166.
34 See, for example, the Workplace Relations Act 1996 (Cth).
employers that allow them to enforce their specific interests.\textsuperscript{36} Both of these alternative options allow a more appropriate and immediate set of remedies.\textsuperscript{37}

**Negative Enforcement of Stakeholder Interests Against Employees**

Directors owe a duty to the company to act ‘in good faith in the best interests of the corporation; and for a proper purpose’.\textsuperscript{38} Where directors make a decision to subjugate the interests of shareholders in favour of employee stakeholder interests, they may be able to argue, as Dodd did, that ‘an attempt by business managers to take into consideration the welfare of employees...will in the long run increase the profits of stockholders’.\textsuperscript{39} It has also been suggested that because the equivalent common law duty (to act bona fide for the benefit of the company as a whole) is fiduciary in nature, this also means that directors should recognise workers’ equitable investments in the firm.\textsuperscript{40}

**United Kingdom**

In 1883, the English Court of Chancery was asked to decide whether the provision of ex gratia benefits to employees was contrary to the interests of the shareholders. In delivering his oft-quoted ‘cakes and ale’ judgment, Bowen LJ decided that ‘liberal dealing with servants eases the friction between masters and servants, and is, in the end, a benefit to the company’.\textsuperscript{41} This principle was not, however, affirmed in \textit{Parke v Daily News Ltd}.\textsuperscript{42}

\begin{itemize}
\item the view that directors, in having regard to the question of what is in the best interests of their company, are entitled to take into account the interests of the employees, irrespective of any consequential benefit to the company…is not the law. [The directors] were prompted by motives which, however laudable, and however enlightened from the point of view of industrial relations, were such as the law does not recognise as a sufficient justification.\textsuperscript{43}
\end{itemize}


\textsuperscript{37} But see \textit{Corporations Act} s 1324: ‘on the application...of a person whose interests...would be affected’, the court may grant an injunction or damages in lieu.

\textsuperscript{38} \textit{Corporations Act} s 181(1) [civil obligation], s 184(1) [criminal obligation].

\textsuperscript{39} Dodd, above n 11, 1156.


\textsuperscript{41} \textit{Hutton v West Cork Rly Co} (1883) 23 Ch D 654, 673.

\textsuperscript{42} (1962) Ch 927.

\textsuperscript{43} \textit{Parke v Daily News Ltd} (1962) Ch 927, 962-963.
DO ESOPS STRENGTHEN EMPLOYEE STAKEHOLDER INTERESTS?

United States

The situation in the US is similar – the principle established in *Unocal Corporation v Mesa Petroleum*,44 and modified in *Revlon, Inc v MacAndrews & Forbes Holdings, Inc.*,45 allows the acknowledgment of the interests of other constituencies, but only as secondary to shareholders’ interests:46

A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on ‘constituencies’ other than shareholders (ie, creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.47

Australia

In Australia, we have no case law directly on point, and it is likely that the decisions in other jurisdictions would allow our courts to recognise shareholder primacy, whilst allowing directors to ‘observe a decent respect for other interests’.48 It has also been argued that the ‘business judgement rule’49 implicitly requires a less shareholder-oriented view, in that the benefit of the corporation as a whole includes the non-shareholder constituents.50

Employees As Shareholders

The discussion until this point has treated employees and shareholders as two distinct groups. However, this does not reflect the realities of today’s stock market, where employees as investors are ‘blurring the boundaries’.51 For example, 92 per cent of Telstra employees acquired shares when the first third of the organisation

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44 (1985) 493 A 2d 946 (‘Unocal’).
48 *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288, 314 (Berger J).
49 Corporations Act s 180(2).
50 Corfield, above n 5, 222-223.
was privatised. Employees may become shareholders either directly in the form of an ESOP, or as independent investors.

**ESOPs**

**What Is An ESOP?**

An employee share ownership plan (ESOP) is a mechanism involving board-sponsored direct or indirect equity participation by employees in their company. Formally, an ESOP is:

a scheme whereby shares are offered for subscription or purchase (or options over issued or unissued shares are offered) only to any or all full or part-time employees (including directors) of the issuing corporation, or a related body corporate or an associated cooperation, who are employed at the time of the offer of the shares or options.

Although variously structured, ESOPs have three common elements:

(a) the transfer of equity to employees;

(b) which is on favourable terms to both employer and employee;

(c) where the equity recipient is an employee of the equity provider.

Although profit-sharing schemes for employees have been in existence since the middle of the nineteenth century, the modern ESOP was developed in the US in the 1970s as a result of the work of Louis Kelso. The generally held belief that ESOPs are a management-oriented vehicle is incorrect – about five per cent (and

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53 It could also be argued that employees are indirect shareholders of listed companies. The superannuation paid on behalf of employees to superannuation companies forms a significant proportion of institutional investments. The connection between employee as superannuant, and employee as shareholder, is beyond the scope of this paper.

54 Australian Securities and Investments Commission Policy Statement 49: Employee Share Schemes, 1995 (hereinafter ‘[PS 49]’), [PS 49.5]. See also Corporations Act s 9.


56 Ibid 2.


DO ESOPS STRENGTHEN EMPLOYEE STAKEHOLDER INTERESTS?

rising) of the Australia workforce participates in some sort of ESOP, and the value of employee-held shares exceeds ten billion dollars. In comparison, employee participation is 7% in UK, 10% in US, and 23% in France. It is estimated that currently, a quarter of all public companies in the US are more than fifteen per cent owned by employees.

Unfortunately, space does not permit an extensive discourse on the objectives, advantages and disadvantages, or on the success or otherwise of ESOPs in Australia and elsewhere.

Corporations Act Recognition

The ASIC position on ESOPs revolves principally around providing relief from the necessity of issuing prospectuses under Corporations Act where the equity to be


Poole, above n 57, 110.

Hirsch, above n 62, 977-981.

Much of the analytical literature in the US revolves around game theory – particularly ‘Prisoner’s Dilemma’. This involves a situation where an individual’s incentive is to ‘shirk’ even though all employees may gain if all cooperate in working harder. ESOPs are seen to be one method of reducing this shirking. For a detailed explanation of ‘Prisoner’s Dilemma’, see Joseph Blasi, Michael Conte, and Douglas Kruse, Employee Stock Ownership and Corporate Performance among Public Companies’ (1996) 50 Industrial and Labor Relations Review 60, 61-63. See also John Coffee, Jr, ‘Unstable Coalitions: Corporate Governance as a Multiplayer Game’ (1990) 78 Georgetown Law Journal 1495, 1533-1538.

An extensive discussion of all aspects of Australian ESOPs can also be found in Richard Stradwick, Employee Share Plans: Equity Participation for Employee Commitment (2nd ed, 1996).

issued as part of an ESOP represents less than five per cent of a class. The reasoning for this is that such an issue ‘does not involve a capital raising’, and the Australian Stock Exchange parallels this strategy in its listing rules. In addition, certain aspects of the Corporations Act covering share buy-backs and financial assistance allow corporations to treat employee share capital transactions in a different manner to those of non-employee shareholders.

Thus we see the accommodation of a special group of shareholders, for no other reason than the fact that they hold employee stakeholder interests.

**Positive Enforcement of Stakeholder Interests by Employee-Shareholders**

Generally, ‘the object [of ESOPs] has been…to achieve financial participation rather than participation in decision-making’. Although ESOPs confer upon employees a personal investment in the governance of the corporation, ‘the impact of employee share ownership on control…is negligible’. This is despite examples like BHP, where about 8% of share capital is held by employees, and Lend Lease where over 20% ($1.6bn) is held by employees.

Any action by shareholder-employees against directors would need to be undertaken as a statutory derivative action.

**Informal Enforcement of Interests**

Companies which have an ESOP, and are comparatively more profitable, usually have implemented that ESOP as part of an organisational philosophy based around higher levels of participation in management issues by employees. ‘The greater the extent of employee ownership the greater the likelihood that some

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69 [PS49], [PS 49.24](a). See also Australian Securities and Investments Commission *Policy Statement 151: Fundraising: Discretionary powers* (2000), [151.7].
70 [PS49], [PS 49.21].
71 Ordinary shareholders need to approve the issue of more than 15% of the share capital: Australian Stock Exchange Listing Rules, Rule 7.1. See also Rules 10.11, 10.12, and 10.14.
72 Corporations Act Part 2J.1.
73 Corporations Act Part 2J.3.
75 Above n 55, 31.
76 Parkinson, above n 74, 425.
77 Hill, above n 51, 222.
78 Above n 55, 28.
79 Corporations Act s 236.
80 Poole, above n 57, 110.
DO ESOPS STRENGTHEN EMPLOYEE STAKEHOLDER INTERESTS?

measure of industrial democracy may accompany financial participation’. However, a consequence of this may be a corporate culture that encourages internal governance inefficiencies – management may be more willing to concede to the wishes of employees, creating a less efficient (ie less profitable and thus less shareholder-oriented) organisation.

**Influence in Shareholder Meetings**

Small groups of shareholders have the right under the *Corporations Act* to call shareholders meetings, and propose resolutions. This allows minority shareholders, like employee groups, to be heard. It is questionable whether this would have a material influence in a formal sense – ‘few dissenting stockholders are in a position to cope with the management (which commonly represents the majority) in a battle to determine where the business interests of the group as a whole really lie’. However, it could be argued that this may have a sufficient influence to make a difference to a public company’s share price, and thus on the voting intentions of institutional or majority investors.

In practice, it is questionable whether employee shareholders would act against their own board given that it could adversely affect their personal wealth. Employees in their stakeholder persona tend to have short term perspectives, which are more dominant than, and run counter to their shareholder persona longer term perspectives.

**Minority Oppression**

It is arguable that the employee-shareholder is in a strong position to enforce their stakeholder rights under Pt 2F.1 of the *Corporations Act*. This provides for the

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82 Hirsch, above n 62, 977-981.

83 *Corporations Act* ss 249D, 249F. Note that s 249D is attenuated somewhat by *Corporations Regulations* reg 2G.2.01 substituting the ‘5% of shareholders by number’ test in place of the ‘100 shareholder’ test under s 249D(1A).

84 *Corporations Act* s 249N(1)(b) – 100 shareholders. Note that in the UK, the 100 shareholder rule has a floor of £100 holding, New Zealand and Canada have no limit, and the US has 1% shareholding threshold with a floor of $US1,000 and a minimum holding period. CASAC has suggested retaining the 100-shareholder limit, but requiring a holding of ‘meaningful economic value, say, $1,000’: *Shareholder Participation in the Modern Listed Public Company, Final Report* (2000) 29.

85 CASAC, ibid 27.

86 Berle, above n 9, 1069.


88 Hirsch, above n 62, 977-981.
court to make an order if the conduct of a company’s affairs is ‘oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or any other capacity’\(^89\) (emphasis added). This is even if the relevant act or omission is against ‘the member in a capacity other than a member’.\(^90\) Although this may appear to be a vehicle for employee interest accommodation, it is unlikely that the courts would support this interpretation.\(^91\)

**Employee Shareholders as Class Members**

It is submitted that in the situation where employee shares are not named as a specific class of shares, employee shareholders can form a ‘class’ either by being issued with shares by the company as part of an ESOP, or by acquiring shares in their own right, and then joining together as a group with a common interest.

**ESOP Members as a Class of Shareholders**

In *Cumbrian Newspapers Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd*,\(^92\) Scott J decided that a class did not need to be named as such, it needed only to exist as a group of shareholders whose rights were different. This decision was followed by Ryan J in the Australian case of *Re A Ffrost & Co Pty Ltd*.\(^93\)

In *Clements Marshall Consolidated Ltd v ENT Ltd*,\(^94\) partly paid ordinary shares were issued to employees of Clements Marhall Consolidated Ltd (‘CMC’). The CMC articles of association differentiated employee shares from ordinary shares until they were fully paid up, at which time they became identical with other ordinary shares.\(^95\) Neasey J stated that the expression ‘class of shares’ had no special meaning – ‘it refers to a category of shares which differs sufficiently in respect of rights, benefits, disabilities, or other incidents, as to make it distinguishable from any other category’.\(^96\)

Employee shares issued under an ESOP commonly carry ‘restricted rights regarding, in particular, votes and transferability’,\(^97\) and given the above would clearly be a distinct class.

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89 Corporations Act s 232(e). For examples of the orders that the court may make, see Corporations Act s 233(1).
90 Corporations Act s 234(a)(i).
91 Corporations Act s 109H.
93 [1993] 1 Qd R 1.
95 *Clements Marshall Consolidated Ltd v ENT Ltd* (1988) 13 ACLR 90, 92.
96 *Clements Marshall Consolidated Ltd v ENT Ltd* (1988) 13 ACLR 90, 93.
DO ESOPS STRENGTHEN EMPLOYEE STAKEHOLDER INTERESTS?

Non-ESOP Employee Shareholders as a Class

An argument can also be established that non-ESOP employee shareholders could constitute a class, as they ‘differ sufficiently in respect of other incidents’.\(^98\) It is submitted that this can be reinforced by the statements made by Bowen LJ in *Sovereign Life Assurance v Dodd* indicating that a class could refer to ‘those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest’,\(^99\) and by Vaisey J in *Greenhalgh v Arderne Cinemas Limited* stating that shareholders are in the same class if their rights are ‘capable of being ascertained by a common system of valuation’.\(^100\) The court would look to the facts of each case; judicial attitude would turn ‘on a value judgment formed in respect of the conduct of the majority – a judgment formed not by any strict process of reasoning or bare principle of law but upon the view taken of the conduct.’\(^101\)

Implications of Class Membership for Employee Shareholders

Having established that employees as shareholders could be identified as a class, whether as part of an ESOP or not, this still leaves open the issue of what employee interests could be enforced. Unfortunately, employees in the position of shareholders would only be able to sue in their capacity as members (not as employees)\(^102\) when the enjoyment of their class rights\(^103\) (not employee interests) have been adversely affected.

Negative Enforcement of Stakeholder Interests Against Employee-Shareholders

There are a number of situations where shareholders may call into question directors’ actions in acting in the interests of employee-shareholders, against the ‘best interests’ of the general shareholders.

An example from the US\(^104\) is *Shamrock Holdings Inc v Polaroid Corporation*,\(^105\) where the directors of Polaroid established an ESOP which had the effect of thwarting a hostile takeover attempt by Shamrock. In applying *Unocal*,\(^106\) it was

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98 *Clements Marshall Consolidated Ltd v ENT Ltd* (1988) 13 ACLR 90, 93.
99 [1892] 2 QB 573, 583.
100 [1945] 2 All ER 719, 723.
101 *Crumpton v Morrine Hall Pty Ltd* [1965] NSWR 240, 245.
102 Sealy, above n 26, 184.
104 See Alexander Gavis, above n 36, 1467, note 79; For examples of cases involving non-shareholder interests being recognised outside Delaware, see Wilson-Leung above n 28, 613, note 138.
decided that the directors could act to the benefit of employees in establishing the ESOP, even though this had the effect of diluting the existing shareholding, reducing dividends, and adversely affecting existing shareholders. It is likely that a similar fact situation would yield the same result in Australia today.107

ESOPs almost always involve executive investment. As such, there is a concern as to ‘whether [they] create an incentive for executives to manage enterprises in a manner that may be contrary to the best interests of non-executive shareholders’.108 Specifically, ‘managers with share options may be using their firm’s resources (in share buy-backs) to increase the short term value of their own holdings’.109

A final point here is that directors may have a tendency to relax their duty of diligence - ‘employee ownership may have a negative effect on firm performance because employee ownership may lead to reductions of managerial control and lower-quality decision making.’110 Directors may also be influenced by the fact that ESOPs decrease employees’ financial diversification.111

Conclusion

Members of the largest non-shareholder constituency – employees – have no directly enforceable interests under the Corporations Act. Similarly, where directors act in the interests of employees, shareholders can claim that directors have breached their duty to act in the best interests of the company unless it can somehow be shown that these actions were for the long term benefit of shareholders. Although employee-shareholders have a slightly higher level of enforceable interests, generally, I would suggest that Australian corporate law is consistent with the thoughts of Milton Friedman:112

The view...that corporate officials...have a ‘social responsibility’ that goes beyond serving the interest of the stockholders...shows a fundamental misconception of the character and nature of a free economy...Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stock holders as possible. This is a fundamentally subversive doctrine.

108 Above n 55, 188.
111 Hirsch, above n 62, 964.
112 Milton Friedman, Capitalism and Freedom (1982), 133.