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# Do ESOPS Strengthen Employee Stakeholder Interests?

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**Abstract**
[extract] 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.

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

# 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.
>
> *Lord Justice Bowen*[1]

## Introduction

It has been said that Australian corporate law favours the interests of shareholders over the interests of other stakeholders – 'the focus…is profit maximisation for the owners of the corporation'.[2] A company may have multiple stakeholders – 'workers, managers, creditors, suppliers, customers and other members of the community'.[3] The largest homogenous group of stakeholders, or as they are sometimes known, 'non-shareholder constituents' for a company will usually be the employees.

The debate over stakeholder orientations extends to the highest levels of politics,[4] and is generally based on the economic success of countries where stakeholder concepts dominate (such as Germany[5] and Japan),[6] though this has been questioned in recent years.[7]

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* 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?'

2 Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance*, Proposals for Reform: Paper No 3 (1997), 60.

3 Ibid.

4 See comments by President Bill Clinton and Prime Minister Tony Blair cited in 'Shareholder Values' (1996), 338 (7952) *The Economist* 13.

5 Jennifer Cook & Simon Deakin, 'Stakeholding and Corporate Governance: Theory and Evidence on Economic Performance' (1999), ESRC Centre for Business Research, University of Cambridge, 5; Andrea Corfield, 'The Stakeholder Theory and Its Future in Australian Corporate Governance: A Preliminary Analysis' (1998) 10 *Bond Law Review* 213, 232.

6 Corfield, ibid 235.

7 'Stakeholder Capitalism' (1996) 338 (7952) *The Economist* 21, 22-23.

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*.[8] 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'.[9] In opposition to this, Professor EM Dodd, Jr argued that although *Dodge v Ford Motor Co*[10] clearly supported this proposition from a legal perspective,[11] the developing feeling was that

> capitalism is worth saving but that it can not 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.[12]

Berle's rejoinder highlighted that this was based on theoretical, and not practical, principles.[13] However, some years later, he acknowledged that 'social fact and judicial decisions'[14] had subsequently prevailed in support of Dodd's viewpoint.

8 See generally Joseph Weiner, 'The Berle-Dodd Dialogue on the Concept of the Corporation' (1964) 64 *Columbia Law Review* 1458.

9 AA Berle, 'Corporate Powers as Powers in Trust' (1931) 44 *Harvard Law Review* 1049.

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.

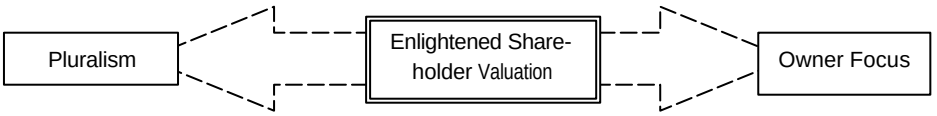
13 AA Berle, 'For Whom Corporate Managers *Are* Trustees' (1932) 45 *Harvard Law Review* 1365, 1367.

14 AA Berle, 'Foreword' in Edward Mason (ed), *The Corporation in Modern Society* (1960), xii.

## 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.

18 Philip Goldenberg, 'Shareholders v Stakeholders: the Bogus Argument' (1998), 19(2) *Company Lawyer* 34, 36. See also The Royal Society for the encouragement of Arts, Manufactures & Commerce, *Tomorrow's Company* (1995); <www.tomorrowscompany.com>.

19 Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999), 36-46. See also critical discussions of this document in Alan Berg, The Company Law Review: Legislating Directors' Duties' [2000] *Journal of Business Law* 472, 475; and in Janice Dean, 'Stakeholding and Company Law' (2001), 22(3) *Company Lawyer* 66.

material, concrete terms.[20] In addition, many stakeholder interests tend to overlap.[21]

## 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.'[22] 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.'[23] 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.[24] 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.[25] The 'emptiness' of this section is further exposed when the absence of suitable remedies is recognised.[26] Current law reform in the UK recommends the retention and rewording of this

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).
24 John Parkinson, 'Reforming Directors' Duties' (1988), *University of Sheffield Political Economy Research Centre Policy Paper 12*, <www.shef.ac.uk/~perc/Polpaps/pp12.html>.
25 Charlotte Villiers, 'UK Report on The Employer and the Relationship between Labour Law and Company Law', <www.labourlaw.it/miscellanea/atti/pontignano2000/Villiers.html>.
26 LS Sealy, 'Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural' (1987) 13 *Monash University Law Review* 164, 177.

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'.[27] 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.[28] 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'.[29] An example of the latter is Connecticut, where directors are *required* to consider (*inter alia*) 'the interests of the corporation's employees'.[30]

### *Australia*

Despite law reform recommendations,[31] Australia currently has no employee-specific provisions in the *Corporations Act*, and as such, directors in Australia owe no duties directly to employee stakeholders.[32] 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.[33]

I would argue that employees as stakeholders are better provided for under industrial relations laws.[34] Alternatively, in line with the 'nexus of contracts' theory of corporations,[35] they can, and do, enter into individual contracts with

27 Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (2000), 29-30.

28 See generally Wai Shun Wilson-Leung, 'The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-shareholder Interests' (1997), 30 *Columbia Journal of Law and Social Problems* 587, 609-620; Marlene O'Connor, 'Symposium: Corporate Malaise – Stakeholder Statutes: Cause or Cure?' (1991) 21 *Stetson Law Review* 3. See also Morey McDaniel, 'Stockholders and Stakeholders' (1991) 21 *Stetson Law Review* 121, 148-161 (comprehensively discussing criticisms and defences of stakeholder statutes).

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.

33 Ivor Francis, *Future Direction – The Power of the Competitive Board* (1997), 353-4.

34 See, for example, the *Workplace Relations Act 1996* (Cth).

35 See Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991), 8-11.

employers that allow them to enforce their specific interests.[36] Both of these alternative options allow a more appropriate and immediate set of remedies.[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'.[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'.[39] It has also been suggested that because the equivalent common law duty (to act bone 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.[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'.[41] This principle was not, however, affirmed in *Parke v Daily News Ltd*:[42]

> 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.[43]

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36 Alexander Gavis, 'A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts' (1990), 138 *University of Pennsylvania Law Review* 1451. But see Kent Greenfield, 'The Place of Workers in Corporate Law' (1998), 39 *Boston College Law Review* 283, 313-321.

37 But see *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.

38 *Corporations Act* s 181(1) [civil obligation], s 184(1) [criminal obligation].

39 Dodd, above n 11, 1156.

40 Janis Sarra, 'Corporate Governance Reform: Recognition of Workers' Equitable Investments in the Firm' (1999) 32 *Canadian Business Law Journal* 384, 399-406.

41 *Hutton v West Cork Rly Co* (1883) 23 Ch D 654, 673.

42 (1962) Ch 927.

43 *Parke v Daily News Ltd* (1962) Ch 927, 962-963.

### *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*').
45 (1986) 506 A 2d 173; See also *Paramount Communications Inc v Time Inc* (1990) 571 A 2d 1140, *Nixon v Blackwell* (1993) 626 A 2d 1366, *Paramount Communications Inc v QVC Network Inc* (1994) 637 A 2d 34, *Herald Co v Seawell* (1972) 472 F 2d 1081.
46 See Robert Art, 'Takeover Legislation: Oregon's Four Approaches to Corporate Protection' (1994) 30 *Williamette Law Review* 223, 257-260.
47 *Unocal* (1985) 493 A 2d 946, 955.
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.
51 Jennifer Hill, 'At the Frontiers of Labour Law and Corporate Law: Enterprise Bargaining, Corporations, and Employees' (1995) 23 *Federal Law Review* 204, 223.

was privatised.[52] Employees may become shareholders either directly in the form of an ESOP, or as independent investors.[53]

## 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.[54]

Although variously structured,[55] 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.[56]

Although profit-sharing schemes for employees have been in existence since the middle of the nineteenth century,[57] the modern ESOP was developed in the US in the 1970s as a result of the work of Louis Kelso.[58] The generally held belief that ESOPs are a management-oriented vehicle is incorrect – about five per cent (and

52 Peter Reith, 'The Role of Employee Share Ownership In The New Workplace', *Breakfast Briefing: Future Directions in Employee Ownership*, <www.dewrsb.gov.au/ministers/mediacentre/printable.asp?show=944>.

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.

55 House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours: Inquiry into Employee Share Ownership in Australian Enterprises* (2000) 19.

56 Ibid 2.

57 See Michael Poole, *The Origins of Economic Democracy: Profit-Sharing and Employee-Shareholding Schemes* (1989).

58 Kelso's work resulted in *Employee Retirement Income Security Act of 1974 (ERISA)*. See also Judith Kenner Thompson, 'Promotion of Employee Ownership Through Public Policy: The British Example' (1993) 27 (3) *Journal of Economic Issues* 825.

rising) of the Australia workforce participates in some sort of ESOP,[59] and the value of employee-held shares exceeds ten billion dollars.[60] In comparison, employee participation is 7% in UK, 10% in US, and 23% in France.[61] It is estimated that currently, a quarter of all public companies in the US are more than fifteen per cent owned by employees.[62]

Unfortunately, space does not permit an extensive discourse on the objectives,[63] advantages[64] and disadvantages,[65] or on the success or otherwise of ESOPs in Australia[66] and elsewhere.[67]

## Corporations Act Recognition

The ASIC position on ESOPs revolves principally around providing relief from the necessity of issuing prospectuses under *Corporations Act*[68] where the equity to be

59 Australian Bureau of Statistics, *Employee Earning, Benefits and Trade Union Membership*, Commonwealth of Australia, 1999, Catalogue no 6310.0, 36 cited in above n 55, 23.

60 Above n 55, 2.

61 'Consultation on Employee Share Ownership' (1999), <www.hmt.gov.uk/pub/html/reg/sharecon.pdf>, 5.

62 Jeffrey Hirsch, 'Labor Law Obstacles to the Collective Negotiation and Implementation of Employee Stock Ownership Plans: A Response to Henry Hansmann and Other 'Survivalists'' (1998) 67 *Fordham Law Review* 957, 959.

63 Poole, above n 57, 110.

64 Hirsch, above n 62, 977-981.

65 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.

66 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).

67 For the most recent information on this, see (Australia) above n 55; (UK) Andrew Pendleton, *Employee Ownership, Participation, and Governance: A Study of ESOPs in the UK* (2001); (US) Blair et al, 'Employee Ownership: An Unstable Force or a Stabilizing Force?' in Margaret Blair and Thomas Kochan (eds), *The New Relationship: Human Capital in the American Corporation* (2000). See also Daryl D'Art, *Economic Democracy and Financial Participation: A Comparative Study* (1992), 282; Andrew Pendleton *et al*, 'The Impact of Employee Share Ownership Plans on Employee Participation and Industrial Democracy' (1995) 5 (4) *Human Resource Management Journal* 44, 57.

68 Divs 2, 3, 3A and s1078.

issued as part of an ESOP represents less than five per cent of a class.[69] The reasoning for this is that such an issue 'does not involve a capital raising',[70] and the Australian Stock Exchange parallels this strategy in its listing rules.[71] In addition, certain aspects of the *Corporations Act* covering share buy-backs[72] and financial assistance[73] 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'.[74] Although ESOPs confer upon employees 'a personal investment in the governance of the corporation,'[75] 'the impact of employee share ownership on control…is negligible'.[76] This is despite examples like BHP, where about 8% of share capital is held by employees, and Lend Lease where over 20% ($1.6bn)[77] is held by employees.[78]

Any action by shareholder-employees against directors would need to be undertaken as a statutory derivative action.[79]

**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.[80] 'The greater the extent of employee ownership the greater the likelihood that some

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.
74 John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993), 423.
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.

measure of industrial democracy may accompany financial participation'.[81] 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.[82]

### Influence in Shareholder Meetings

Small groups of shareholders have the right under the *Corporations Act* to call shareholders meetings,[83] and propose resolutions.[84] This allows minority shareholders, like employee groups, to be heard.[85] 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'.[86] 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.[87]

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.[88]

### 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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81 Andrew Pendleton, 'ESOPs and Employee Relations' in Nicholas Wilson (ed), *ESOPs: Their Role in Corporate Finance and Performance* (1992), 227, 235. See also Michael Glanzer, 'Union Strategies in Privatisations: Shakespeare-inspired Alternatives' (2000) 64 *Albany Law Review* 437, 481-484.

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.

87 See Paul Redmond, *Companies and Securities Law: Commentary and Materials* (3rd ed, 2000), 328-332.

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.

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.
92 [1987] Ch 1.
93 [1993] 1 Qd R 1.
94 (1988) 13 *ACLR* 90.
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.
97 Paul Davies & Daniel Prentice, *Gower's Principles of Modern Company Law* (6th ed, 1997), 320.

### *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

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.
103 See generally Elizabeth Boros, *Minority Shareholders' Remedies* (1995), 79-80; *Greenhalgh v Arderne Cinemas Ltd* [1946] 1 All ER 512.
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.
105 (1989) 559 A.2d 257.
106 *Unocal Corporation v Mesa Petroleum* (1985) 493 A 2d 946.

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.

107 *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, adapting the 'proper purposes' doctrine in *Hogg v Cramphorn Ltd* [1967] Ch 254.
108 Above n 55, 188.
109 'Share and share alike', *The Economist*, 7 August 1999, 19 cited in above n 55, 196.
110 Rayna Brown and Cheung Wah Lau, 'The Extent and Industrial Pattern of Share Ownership Plans in Australia: Preliminary Evidence' (1997) 10 (1) *Accounting Research Journal* 34, 35.
111 Hirsch, above n 62, 964.
112 Milton Friedman, *Capitalism and Freedom* (1982), 133.