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Shareholder Primacy and Algorithmic Governance: Reconstructing the Conflict Between the Friedman Paradigm and the ESG Framework

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Abstract

This paper explores the paradigm conflict between Milton Friedman's shareholder primacy doctrine and the modern ESG (Environmental, Social, and Governance) framework. Grounded in the legal fiction of corporate personhood and the neoclassical model of profit maximization, Friedman's theory disregards the embedded social and ethical responsibilities of businesses. Through a philosophical critique and legal analysis—including Burwell v. Hobby Lobby and Section 172 of the UK Companies Act—this study reveals the ethical limitations and practical obsolescence of Friedman's framework.

The institutionalization of ESG, driven by technological innovations (e.g. blockchain verification, AI ethics auditing), fiscal policy, and geopolitical dynamics, is shown to fundamentally reshape global business logic. Yet, ESG is not without its paradoxes. Issues of methodological opacity, "ratings capitalism," and algorithmic manipulation—exemplified by the S&P ESG index controversies and AI-generated sustainability reports—highlight its governance challenges.

In conclusion, while ESG revises the foundational logic of commercial civilization from profit maximization to systemic resilience, Friedman's doctrine retains relevance in specific geopolitical and regulatory contexts. The future of corporate ethics lies not in binary opposition, but in dialectical reconciliation—where social responsibility emerges as both constraint and strategic opportunity in a complex risk-based economy.

Keywords

ESG Paradigm Shift; Corporate Legal Fiction; Friedman Doctrine; Green Premium Strategy; Social Risk Internalization

1 Paradigm Conflict between Friedman's Propositions and ESG

1.1 The Philosophical Kernel of Friedman's Doctrine

The core of Friedman's doctrine, shareholder supremacy, rests on the philosophical premise that the corporation is reduced to a 'legal fiction'. This presupposition stems from Ronald Coase's classic theory of the corporation as a 'nexus of contracts', but Friedman transformed it in a one-way street: he stripped away the complexity of the transaction cost analysis of Coase's theory and emphasised the corporation's singular responsibility as the agent of the shareholders' estate[1]. This 'legal fiction' deliberately ignores the socially em-

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bedded nature of business, relegating stakeholders such as employees, the community and the environment to external variables in the execution of contracts, whose rights and interests are only reflected in the minimum constraints of the law (e.g., labour law compliance), rather than in the ethical obligations of the business. Academics have also been critical of this, with Stout pointing out that more than 90 per cent of state corporate laws in the US already allow directors to consider non-shareholder interests through other stakeholder statutes (Constituency Statutes).[2] And in the bankruptcy of the perfect information hypothesis, behavioural economics research demonstrates that systematic cognitive biases lead to market failure, directly challenging Friedman's rational market model3]. The bankruptcy of the perfect information assumption usually refers to the fact that in real economies and financial markets, information is not always fully transparent or accessible, leading to market failures or biased decision-making. At the same time a blind belief in profit maximisation inevitably leads to Pareto optimality. But the fatal flaw of Pareto efficiency is that it does not care about initial distributive justice, and even if the Pareto improvement is satisfied, the risk of social tearing is still increasing. And ignoring distributive justice by maximising profits fails to deal with intergenerational equity (e.g. issues such as climate change). By equating profit maximisation with an ideological narrative of social progress, Friedman is essentially stealing the mathematical model of neoclassical economics for an ethical code. In this case, Burwell v. Hobby Lobby, the central question in the case was: can a privately held, for-profit corporation deny insurance coverage for certain contraceptives to its employees based on religious beliefs? The U.S. Supreme Court acknowledged that corporations can refuse to maximise profits based on religious ethics, but the decision sparked fierce opposition from Friedmanites. Section 172 of the UK Companies Act 2006 [4] explicitly states that directors are required to ‘promote the success of the company’ by taking into account the interests of employees, the community and the environment, and explicitly rejects a single-shareholder orientation. It is clear that the vacuum of the Friedman Doctrine has been filled by a three-dimensional liability framework: carbon pricing for environmental externalities (E), return on investment (ROI) measurement for human capital (S), and quantitative indicators for board risk monitoring (G), which together constitute a systematic deconstruction of the Friedman Paradigm.

1.2 ESG and Friedman Doctrine Paradigm Conflict Focal Points

The confrontation between the Friedman Doctrine and the ESG framework is essentially a fundamental dichotomy between the two business philosophies in terms of time dimension and responsibility boundaries. This conflict is not only reflected in the theoretical level, but also triggers institutional restructuring, capital flow and strategic revolution in global business practice. In the invisible battlefield of time discount rate, short-term profit and long-term value are playing with each other, which is one of the focal points of the paradigm conflict. At the heart of the Friedman Doctrine is the maximisation of present value for shareholders, with the implicit assumption that future risks can be priced instantly through the market and that firms are not responsible for long-term externalities. Examples include oil companies deferring investment in renewable energy for a long time to maintain quarterly dividends, and odd-job platforms that maximise immediate labour output through algorithms that ignore the physical and mental health of their employees. The ESG framework, on the other hand, requires companies to incorporate intergenerational equity and systemic resilience into their decision-making models, compressing profits in the short term and creating a violent collision between the two views of time in order to reduce the risk of organisational rigidity in future technology iterations. The essence of the conflict is that the Friedman model relies on a high discount rate to discount future

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costs to a present value close to zero, while the ESG model adopts a low or even negative discount rate, recognising the irreversible costs of ecological collapse and technological disruption. This difference in temporal perspective leads directly to a split in the logic of capital allocation. Nor is the focus only on the above. There is also a reconfiguration of the boundaries of responsibility, with the Friedman Doctrine treating the enterprise as the private property of shareholders, with managers as agents accountable only to the owners, while the ESG framework defines the enterprise as a socio-technical system, whose survival relies on the symbiosis of multiple actors, such as employees, the community, the environment, and so on. Shareholder supremacy presupposes clear boundaries of rights, while ESG recognises corporations as open nodes nested in social-ecological systems. When climate change forces corporations to take responsibility for global carbon budgets, and when employees leave their jobs to protest the lack of a diverse and inclusive culture, shareholders can no longer monopolise the right to define corporate goals through legal ownership. Of course the paradigm clash between the Friedman Doctrine and ESG will not end with one side annihilating the other, but rather the collision will give rise to hybrid business forms.

2 The Practical Rejection of Friedman's Propositions by ESG in Different Dimensions

2.1 The Environmental Dimension: Carbon Constraints

In the environmental dimension, the two present a fundamental paradigm difference, Friedman believes that the environmental problem is an ‘externality’, enterprises only need to comply with the existing laws, and do not need to take the initiative to assume the responsibility of emission reduction; while the ESG framework is through the policy coercion, the market pricing and the technological lock-in effect, the conversion of carbon emissions from an external cost to the core variables of the enterprise balance sheet, systematically subverting the traditional business logic. The ESG framework transforms carbon emissions from an external cost to a core variable in the balance sheet of enterprises through policy enforcement and market pricing and technology lock-in effects, systematically subverting traditional business logic. The European Union's Carbon Border Adjustment Mechanism (CBAM),[5] which requires importers to purchase CBAM certificates based on the implied carbon emissions of their products, is forcing multinationals to reevaluate the locational efficiency of their global supply chains.

The capital market has reconstructed asset valuation models through the Green Premium mechanism to measure the economic viability of green technologies in order to promote the goal of carbon neutrality. Notably, the maturation of the carbon credit trading market has allowed carbon credits to evolve from an abstract environmental element to a fully liquid financial asset, allowing companies to manage their carbon accounts and even trade carbon credits as if they were cash flows. Meanwhile the UK has established the world's first emissions trading system (UK Emission Trading Scheme ,UK ETS) and replaced the UK's participation in the EU ETS on 1 January 2021, which is seen as a key step towards achieving the UK's goal of reaching net-zero carbon emissions by 2050, with plans to reduce the existing emissions cap by 5% in an attempt to go further than the EU ETS to go further than the EU. In addition, the UK participates in the Carbon Pricing Leadership Coalition (CPLC) and the Partnership for Market Readiness (PMR), which promotes the development of global carbon pricing and co-operation. With the formation of a transmission mechanism from carbon price

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volatility to the end price of commodities, investment in emission reduction has essentially been transformed into a strategic choice to safeguard shareholders' interests when the cost of carbon becomes a dominant variable that erodes profitability. The point of conflict between corporate environmental responsibility and financial performance is strongly attenuated. The green economy, such as carbon constraints, no longer becomes the enemy of profit, but a foundational parameter of the new business civilisation. Companies that still try to avoid climate action under Friedman's theory will find themselves excluded from mainstream supply chains, capital markets and technological ecosystems.

2.2 Social Dimensions

The ESG framework reveals the strategic value of human capital through legal coercion, empirical evidence of productivity correlation and social risk pricing. Global legislative trends are transforming social risk from an ethical choice to a legal responsibility, directly challenging Friedman's logic of 'cost minimisation', whereby the externalities of social costs are being forced to be internalised through legislation, and companies are no longer able to pass human rights risks on to disadvantaged groups or governments. Section 3(2) of the German Supply Chain Due Diligence Act[6] requires companies to properly fulfil their human rights and environmental responsibilities in their supply chains and to ensure that their business activities do not violate fundamental rights or cause environmental damage. With ESG, labour rights litigation is reshaping corporate cost structures. In Uber BV v Aslam (2021) [UKSC 5][7], Uber argued that its drivers were independent contractors, not 'workers', and were therefore not entitled to the protection of labour laws such as minimum wage and paid leave. Uber drivers sued, arguing that they should be treated as 'workers' and entitled to the relevant rights when working on the Uber platform. However, in the final decision of the UK Supreme Court, the Court emphasised that Uber's high level of control over the way drivers work, such as setting prices, managing the rating system, and restricting direct communication with passengers, suggests that drivers are not truly independent contractors, but rather 'workers', and that drivers are considered to be in a state of work, with rights such as minimum wage and paid time off, when they turn on the Uber app and are willing to accept an order. Drivers are considered to be in a state of work and should be entitled to, inter alia, minimum wage and paid leave. The case also had a financial impact on uber, with Uber UK's 2023[8] financial results showing, a 23 per cent increase in compliance costs (around £420 million), leading to the first loss for the European business. ESG practice reveals that one of the fundamental flaws in Friedman's model is that it treats human expenditure as a short-term variable cost, ignoring its long-term earnings attributes as a strategic asset. It also fails to anticipate the path of social risk backfiring on shareholder value through the capital markets.

2.3 Governance Dimension

While traditional boards have a single objective of maximising shareholder value, ESG requires them to take on a broader systemic risk management function, and director responsibilities are expanding towards ESG risks. In his article[9], Campbell finds that gender diversity (as measured by the percentage of women on the board of directors and the Blau and Shannon indexes) has a positive effect on firm value, while the opposite causality is not significant, through a study that shows that Spanish investors do not penalise firms that increase the number of female board members, and that greater gender diversity may generate economic gains. This effect stems from the correction of the decision blindness by the diversity perspective. In California SB-826 (2018)[10], Corporations Code §301.3 mandates that all public companies with a principal exec-

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utive office in California must have at least one female director on their boards of directors, and companies may face fines of up to $300,000 if they fail to comply. This is a side effect of the fact that board diversity is no longer just a moral imperative, but a quantifiable competitive advantage.

3 ESG Institutionalisation Reshapes Business Logic in Different Ways

ESG rules are evolving from a voluntary initiative to a legally binding global compliance network in which companies are included regardless of their domicile or market scope. Article 19b of the EU's CSRD[11] requires non-EU companies to disclose supply chain ESG risks if they have annual revenues of more than €150 million in the EU. The enactment of this regulation requires multinationals to internalise the cost of ESG systems as a fixed expense of global operations, rather than a selective optimisation item. At the same time, the convergence of standards from the International Sustainability Standards Board (ISSB) and the Financial Accounting Standards Board (FASB) has further blurred the boundaries between financial and non-financial information, making carbon emissions data a quantifiable liability on the balance sheet.

The convergence of blockchain and IoT technologies is shifting ESG governance from 'after-the-fact reporting' to 'real-time verification'. Data such as supply chain carbon footprints and factory labour conditions are written into a distributed ledger, and any tampering will trigger the automatic penalty mechanism of smart contracts. This technology-enabled transparency not only squeezes out the room for 'greenwashing', but also reshapes the rules of business competition. Companies must invest in verifiable ESG infrastructure to gain the trust of customers and investors. The evolution of AI ethical auditing tools has enabled human rights risk monitoring to move from sampling to full analysis, dramatically increasing the probability of detecting violations, and De Beers has seized the opportunity to launch a 'carbon fingerprinting' blockchain system in 2024 to track the carbon emissions of individual diamonds from mining to retail. The system relies on blockchain technology to ensure transparency and traceability in the diamond supply chain. Compliant diamonds receive a 23 per cent premium in the market due to their verifiably low carbon footprint, and De Beers' Tracr platform continues to evolve as the world's leading blockchain tracking system for diamonds, ensuring authenticity and continuity. This technology not only enhances consumer trust in the origin of diamonds, but also pushes the industry in a greener, more responsible direction.

Geopolitical internalisation, where major economies compete for global rule-making power through ESG standards, and companies are forced to strategically arbitrage between multiple standards. Policies vary from region to region, as in the case of the UK government, which has formulated a series of policies, regulations and action plans in the area of green finance, providing clear objectives and frameworks for the development of green finance. Incidentally, the Government encourages and supports the participation of financial market participants in green finance activities through the provision of fiscal and tax incentives, guarantees and subsidies, etc. In particular, for small and medium-sized enterprises (SMEs) and entrepreneurs, the Government provides special green financial services and platforms to help enterprises access financing and investment opportunities for green projects and industries. Not only that, but the establishment of institutions such as green investment banks, green finance and investment centres has also been used to provide professional data and analysis services, as well as risk-taking and capital-providing functions for the development of green finance. It is also indispensable in terms of technical support, which is mainly reflected in the following: first,

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the use of big data, artificial intelligence, blockchain and other emerging technologies to improve the transparency, quality and consistency of the information disclosure of green finance, as well as the efficiency and effectiveness of the risk management of green finance. The UK government-supported Green Finance and Investment Centre, for example, uses artificial intelligence and satellite data to provide world-class data and analytics services to financial institutions, helping to make better investment and business decisions when considering the impacts of the environment and climate change. Secondly, the use of innovative technologies, such as clean technologies, new materials and new energy sources, has improved the technological level and competitiveness of green projects and industries. In its Ten-Point Plan for a Green Industrial Revolution[12], the British Government has put forward a series of technological innovation targets and measures in such areas as clean energy, transport, nature and innovative technologies, with a view to promoting the transformation and growth of a green economy. Thirdly, the popularity and coverage of green finance should be enhanced, and the social impact and public participation in green finance should be strengthened.

4 Limitations of ESG and Problems Encountered with Green Finance and ESG

ESG in practice is prone to the trap of alienation, with ESG scoring systems spawning ‘ratings capitalism’ due to opaque methodologies and fragmented criteria. In 2024, the S&P 500 ESG Index excluded Tesla but included oil companies, including ExxonMobil. This decision was widely questioned by the market, as fossil fuel companies such as ExxonMobil are often considered major contributors to global carbon emissions, while Tesla, as the world's leading manufacturer of electric vehicles, has played an important role in promoting low-carbon transport. However, S&P's rating system found Tesla deficient in its low-carbon strategy and code of business conduct. Additionally, Tesla's ESG score was impacted by workplace issues and allegations of racial discrimination at its Fremont, California, factory. S&P noted that African-American employees at the factory were subjected to a long history of racial slurs, including words described as discriminatory, and that the company failed to effectively address these issues. The incident exposed the subjective and opaque nature of the ESG rating system. How rating agencies define ‘materiality issues’ is a key factor in the ratings. For example, an oil company may be included in an ESG index because it may have a better governance structure or socially responsible investments, even though its carbon emissions are much higher than those of an electric car manufacturer. This leads to the possibility that companies may strategically disclose certain favourable information rather than actually improving their ESG performance. Such contradictions stem from the subjective judgement of rating agencies on ‘materiality issues’, which leads to strategic disclosure for the purpose of scoring, rather than real improvement in ESG performance. Moreover, with the development of artificial intelligence, ESG reports generated using generative ai have a 67 per cent probability of passing the SASB's materiality analysis, but 42 per cent of the environmental data is fictitious.[13] The existence of such fictitious data further exacerbates the opacity of the ESG rating system, making it more difficult for investors to judge the true level of sustainability of companies. For regulators, how to ensure that AI-generated ESG reports meet authenticity standards and reduce the dissemination of false information has become an important challenge to be addressed in the future. Although ESG and green finance have developed quite a lot to a certain extent, there are some problems and challenges: specifically for the UK, there is no unified ESG definition and classification, nor is there a mandatory ESG reporting standard and framework, leading to the exis-

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tence of different ESG methodologies and tools in the market, resulting in inconsistent and incomparable information. For legislators, the UK's green finance policies and regulations also do not fully take into account the characteristics and needs of different financial institutions and products, and there may be a one-size-fits-all tendency, affecting the efficiency and effectiveness of green finance. Green finance regulation involves a number of departments and agencies, including the Ministry of Finance, the Financial Reporting Council, the Financial Conduct Authority, the Financial Policy Committee and the London Stock Exchange. Coordination and communication between these sectors and institutions may be inadequate, leading to problems of regulatory duplication and deficiencies, regulatory inconsistencies and imbalances. Green finance regulation mainly focuses on information disclosure requirements, while incentives and constraints for green finance are relatively lacking, leading to a mismatch between the supply and demand sides of green finance. In addition, the UK's green finance regulation does not make full use of the power of third parties, such as industry associations, professional organisations and rating agencies, to improve the efficiency and effectiveness of regulation. Although green financial policies and regulations have relatively sound provisions on paper, there may be some difficulties and obstacles in the actual implementation process.

5 Summary

Although ESG has reconfigured the underlying logic of the business world, the Friedman Doctrine has not completely died out, but rather has demonstrated the resilience of instrumental rationality in specific scenarios, where companies can still rely on the logic of maximising shareholder interests to achieve short-term gains in weakly regulated or geo-politically sensitive regions such as the Middle East's petrochemical industry. Even in the process of mainstreaming ESG, shareholder litigation remains a counterbalance to prevent management from deviating too far from its financial goals. The Friedman paradigm retains a voice in the judicial system, ensuring that ESG transformation does not depart from a risk-adjusted rational framework. Business civilisation is now making the leap from the unidimensional logic of ‘shareholder primacy’ to the complexity of ‘systemic symbiosis’. The driving force behind this transition may not be a traditional moral awakening, but rather a revolutionary reconfiguration of risk-pricing mechanisms - as the costs of climate change, social conflict and governance failures are precisely internalised, companies are finding that Friedmanian profit maximisation has to pass through the narrow door of ESG constraints. However, this ‘evolution’ is far from a linear narrative of progress. The institutionalisation of ESG has revealed the limits of technological governance: it cannot replace the value-ordering function of democratic politics, nor can it remove the fundamental tension between capital growth and social well-being. The real challenge for the future is how to build a dynamic and resilient new business ethic between quantitative responsibility and pluralistic values, between the pursuit of efficiency and inclusive growth, between global standards and local contexts. Perhaps the greatest lesson from the advancement of modern business civilisation is that corporate ‘social responsibility’ is neither the antithesis of profit maximisation nor an additional obligation under the aura of morality, but rather the two sides of the coin of risk and opportunity in a complex system. Only by acknowledging this dialectic can we find a way for business civilisation to survive between subversion and continuity, between ideal and reality.

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