

## **The Case of the Detrimental Drug: Implications for the Stakeholder Theory of Directorship**

J. Scott Armstrong

The Winter 1979 issues of *Directors and Boards* presented readers with a questionnaire based to a degree on a 1969 board incident at Upjohn Corporation [see Box 1 (on page 2) and Box 2 (on pages 3-4)]. In this questionnaire, a profitable drug named “Wondola” was being produced by the so-called International Drug Corporation (IDC). Readers were told that members of the American Medical Association's Council on Drugs had objected to the sale of most fixed -ratio (combination) drugs on the grounds that they grant no benefits superior to those of single-ingredient drugs, and are more likely to produce detrimental side effects, including death. Wondola, with an approximated fatality record of 14 to 22 deaths per year, was no exception. The Federal Drug Administration had asked IDC to withdraw the drug. Readers were asked how they would have voted at a board meeting called to resolve the withdrawal issue.

Several months after the publication of the first questionnaire, follow-up questionnaires were sent to *D&B* readers and to select corporate constituents. These letters solicited comments on a “stakeholder” theory of board membership which I proposed in conjunction with the Wondola experiment. In the following pages, I present the background of the experiment. The stakeholder theory will then be proposed as a solution to the “responsibility dilemma” the Wondola case raises. Finally, questionnaire respondents will speak for themselves on this complex issue.

### **Early research results**

The Wondola case, drawn from Morton Mintz's coverage of the controversy surrounding the Upjohn drug Panalba, was used in a research project I conducted from February 1972 to March 1977, the results of which were published in the year of its completion.<sup>1</sup> Since 1977, discussions and summaries of the project have appeared on radio and television, as well as in newspapers and periodicals, demonstrating it to be a subject of public interest.

The participants in the early Panalba-based project were drawn from management courses and seminars attended by undergraduate and graduate students as well as executives. Thirty-three people administered the experiment as a teaching vehicle in ten countries (the number of experiments conducted in each is indicated in parentheses): U.S. (166), Sweden (109), Belgium (11), France (8), Canada (6), Norway (4), England (8), Denmark (3), Finland (2), and Mexico (2). No one in the sample had heard of Panalba. Subjects received background information on the case [see Wondola questionnaire, pages 6-7 below]. Once assigned roles, they were divided into 7-person groups, each of which represented the Board of Directors of the Upjohn Corporation. My colleagues and I tried to make the roles conform closely to those of the Upjohn board members in 1968, using both Upjohn's annual report for that year and Mintz's study as bases. This required some improvisation, since Mintz did not report some of the information needed for such a recreation, and the Upjohn Corporation, prior to publication of this experiment, was not willing to comment on the case. Participants were asked to act as if they had assumed the role of the person described.

Of the 57 groups in the control condition for role playing, none removed the drug from the market. Furthermore, 79 percent of these groups selected *e*, the most extreme decision to take “legal, political and other necessary actions to prevent authorities from banning Panalba.”

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<sup>1</sup> Morton Mintz, “F.D.A. and Panalba: A Conflict of Commercial and Therapeutic Goals,” *Science* (1969), pp. 875-81. My research was published in “Social Irresponsibility in Management,” *Journal of Business Research* (Sept. 1977), pp. 185-213.

On the other hand, when a similar subject population was tested for its reaction to such decisions without having been assigned roles, the majority of them deemed the continued sale of the drug irresponsible.

It would seem then that action and contemplation yield different choices. How is this possible?

This question has general implications for corporate boards. The specific points of the Panalba story are not of major concern here – neither is the fact that the real and recreated Upjohn board members pursued choice *e*. The experiment could have been based on any one of countless cases in which board members – with varying degrees of awareness of product danger-have allowed detrimental products to be sold. Consider the current example of SmithKline’s Tagamet, or the cases of Occidental Chemical Company and asbestos, Allied Chemical and Kepone, DuPont and benzidine, Ford and Pinto – all recently reviewed in light of proposed bill HR 4973, “to amend title 18 of the United States Code to impose penalties with respect to certain nondisclosure by business entities with respect to dangerous products.”<sup>2</sup> The point is that when faced with a choice between benefiting stockholders or other constituencies, the director in our current board structure will favor the former *even* if the thought of bringing detriment to other parties provokes clashes with his or her conscience.

### UPJOHN’S VIEW ON PANALBA

Armstrong has based his research on a corporate decision-making case detailed by Morton Mintz, “FDA and Panalba: A Conflict of Commercial and Therapeutic Goals,” (see endnote 1). Since Mintz wrote his piece, both pro- and anti-Panalba sides have had their additional say in this project. The producer of Panalba, Upjohn, has been contacted from the early stages of Armstrong’s research. In a letter dated October 30, 1979, Joseph T. Heywood, Upjohn’s Director of Corporate and Media Relations, cited the May 1979 statement of Upjohn President Dr. William N. Hubbard, Jr. Addressing shareholders at the company’s annual meeting, Dr. Hubbard stated:

“Finally, and in a somewhat different context, I would call to memory the departed fixed combination of tetracyclin and novo-biocin named Panalba. I would suppose that no single therapeutic agent in the history of pharmacology has ever been subjected to the kind of criticisms that this preparation received at the time when controlled clinical trials became, through regulation, the unique source of acceptable data for effectiveness. Panalba was, as you all know, withdrawn from the market under pressure of these attacks.

“Today, I would simply recount that, in laboratory experiments, it has now been well demonstrated that the fixed combination is more effective than either

compound separately in the inhibition of resistance in some microorganisms found in common respiratory infections.”

In his recent letter, Heywood points out that Panalba has been sold outside the U.S. as AlbamycinT for the past 20 years. Among the thirty countries which approve general use of this drug, Upjohn cites the United Kingdom, Canada, France, Switzerland and Belgium. All of these countries, Heywood argues, “possess regulatory authorities on par with FDA, and in some cases may exceed FDA in expertise and effectiveness in the public interest. The authorities in these countries did not agree with FDA and its decision on fixed combination antibiotics.”

Heywood closed his letter with the following strong words: “The Upjohn Company continues to believe that the FDA’s action against the product was arbitrary and capricious. The FDA action injured the company financially, but, more importantly, it denied physicians and patients the use of a very useful medicine. Given the same situation, we would fight FDA in the courts again, not because of ‘blind obedience to authority,’ but because FDA was wrong.”

<sup>2</sup> Cf. Scott A. Baris, “Smith Kline’s Revival: But A New Drug Triggers a Controversy,” *New York Times* (Sept. 16, 1979), pp. 1 ff., and Democratic Rep. George Miller, remarks on “Corporate Responsibility and Hazardous Materials,” in the House of Representatives, 96th Congress, November 15, 1979 [rep. in the Congressional Record](#) (Nov. 15, 1979), E5656-59.

## INSTRUCTIONS IN THE ORIGINAL PANALBA EXPERIMENT\*

**Instructions.** The major instructions given to the subjects are provided below. The italicized statements were also written on the blackboard.

"I am providing one envelope to each group. *Please do not write on these materials unless you are the Chairman.* The Chairman will complete a group decision form. When you receive the envelope, please remove the contents, take the 'role' on top and pass the roles to the person on your right, etc., until everyone has a role.

"When you receive your role, remove the 3 x 5 card and place it on you or in front of you so that the others in your group can tell who you are. Then read your role and *act as you would act if you were in the role which is described.* (Repeat this.) *Improvise as necessary but do not step out of your role.* The roles all differ, so do not discuss your role with others in your group.

"This meeting has been called by E. G. Upjohn, the Chairman of the Board at Upjohn. Due to time pressures, your group must reach a decision in 45 minutes. Dr. Upjohn will start the meeting as soon as you have read your roles."

### Roles for "Traditional Board"

**Chairman of the Board.** As Chairman of the Board, it is your job to have the Board reach a decision on the two issues within the time allowed. Unfortunately, you have only 45 minutes to reach a decision since some of the Board members can stay no longer than that.

Your general philosophy about meetings is to try to allow for various sides of the issue to be discussed before a decision is reached.

Legally speaking, a majority vote is required in order to reach a decision. You prefer that a consensus be reached, but a formal ballot may be used at the end of the meeting if necessary. Please record the group decision on the form which has been given to you and give it to the administrator of this case.

**Vice Chairman of the Board.** You were the President of Upjohn when Panalba was introduced into the market. Naturally, you feel that Panalba was, and still is, a good product both for Upjohn and for the people who have used it. If you didn't feel this way, you would never have put Panalba on the market in the first place.

**President.** You have been President for two years. Since your appointment, the economy has slowed down and, as a result, company profits have decreased. The Panalba problem seems to have surfaced at an especially bad time.

You have been checking out various ways of handling the Panalba problem. One suggestion has been sent to you by an Upjohn lawyer. He had seen the Panalba issue develop over the past few years. He thinks that it would be possible to delay any action by the FDA. He suggests that Judge Kent of Kalamazoo (a man whom you know personally) would be willing to serve an injunction on the FDA. The injunction would prohibit the FDA from banning Panalba until such time as a formal hearing can be held. The results of the hearing, if unfavorable, could then be appealed. In effect, the case could be tied up in the courts for years. And, if the court action were successful, it would help to prevent the FDA from moving against other drug products in the future.

Another suggestion was sent to you by the Upjohn lobbyist in Washington. He suggests that it might be possible to bring political pressure to bear and to attempt to have Robert Finch, head of HEW (and therefore having jurisdiction over the FDA), overrule the proposed action by the FDA.

**Vice President and Director.** In light of the bad publicity given Panalba, you have sought suggestions for combatting it, and favor one: that a strong plea be sent to all doctors to protest to the FDA on the grounds that the FDA would be violating the physician's right to prescribe if Panalba were removed. You feel that the fact that the doctors have been using Panalba for the past 13 years indicates that it must have some value.

You've been a member of the Board of Directors for 8 years and you own 20,000 shares of Upjohn stock.

**Executive Vice President.** You have been on the Board of Directors since 1955 and you own about 25,000 shares of Upjohn stock.

**President: William John Upjohn, Assoc., Inc., Marketing and Advertising Consultants.** You are part of the Upjohn family and you own a considerable amount of stock. Your consulting firm does most of its work for the Upjohn Co.

**Stockholder.** You are a practicing M.D. You've been prescribing Panalba for years and you have seen nothing wrong with it.

### **Description of the Roles for the Democratic Board**

The roles of *Chairman*, *President*, and *Stockholder* are exactly the same as those for the traditional board. The four new roles are as follows.

**Public Representative.** You have been selected by the Mayor to represent the community interests. The Mayor had to find someone who would represent all groups in the local community and your decisions are reported in the local papers. Prior to the meeting, you had not been able to think of any major impact which the ban on Panalba might have. True, there will be some impact on the employment level, but the community is so large that this would be very minor.

You hold no shares of Upjohn stock.

**Suppliers' Representative.** You represent the organizations that sell goods and services to Upjohn. Upjohn, of course, represents only a small part of each supplier's sales. And if the purchase were made instead by a competitor of Upjohn, the firm would also obtain

its supplies from the firms which you represent. Your job is to try to make sure that the suppliers receive fair treatment. Whether or not Panalba will stay on the market is of little importance to the suppliers.

You own no shares of Upjohn stock.

**Consumer Representative.** You are elected by a consumer's group. Your job is to ensure that the interests of the consumer are protected. Your decisions are widely reported by the press and by such groups as Consumer's Union. You have reviewed the evidence behind the Panalba case and you feel that the background information which was sent to the members provides a fair picture of the effect of Panalba upon consumers.

You hold no shares of Upjohn stock.

**Employee Representative.** You have been elected by the employees and they expect you to represent their interests. You have been a director since 1969.

You've given some thought as to what would happen if Panalba were to be banned from the market. Approximately 200 jobs would be eliminated (out of the roughly 5,000 jobs at Upjohn). Naturally, your constituents won't be too happy about this.

You hold no shares of Upjohn stock.

\*Abstracted from J. Scott Armstrong, "Social Irresponsibility in Management," *Journal of Business Research* (September 1977), pp. 185-213.

### **The role/individual dichotomy**

The Panalba research is one of many studies which have examined the strong influence exercised by authority, such as those summarized in *Obedience to Authority* (Milgram, 1974). These studies reveal that people are likely to do things within the framework of a particular organizational role which they would never do as individuals. In a sense, a role relieves them of responsibility for their actions. In the Panalba case, the board members presumably thought it unfortunate that the chances of consumer death were raised by the use of this product as opposed to the use of its substitutes, but in their principal role as stockholder advocates, they did not seem to feel responsibility toward consumers. Milgram drew the following conclusion from his research:

... ordinary people, simply doing their jobs, and without any particular hostility on their part, can become agents in a terrible, destructive process. Moreover, even when the destructive effects of their work becomes patently clear, and they are asked to carry out actions incompatible with fundamental standards of morality [especially if they are told that they will not be held personally liable for it], relatively few people have the resources needed to resist authority.<sup>3</sup>

<sup>3</sup> Stanley Milgram, *Obedience to Authority: An Experimental View* (New York: Harper and Row, 1974). Bracketed remarks concerning liability are extrapolated from Milgram's noted "shock-treatment" experiment conducted at Yale University. This experiment, documented in the above work, purported to assign subjects randomly to a "teacher" or "learner" role using shocks as punishments. Subjects, believing they had been randomly selected as "teachers" (they were actually placed in the role on purpose)

## Identifying socially responsible directors

Is it possible to tell whether or not a given board member is intrinsically “socially responsible”? Research to date suggests that it is not. In the Panalba case, we found no differences among participants from 10 countries. Nor was age important, although the older managers exhibited a tendency to act more “responsibly.”

It would be difficult, to say the least, to “educate” directors in social responsibility. Long after Aristotle's *Nicomachean Ethics* posed the question “Can ethics be taught?” Baumhart provided evidence that neither religious training nor courses in ethics can bring about socially responsible behavior.<sup>4</sup> Even if corporations could initiate their directors in modes of social consciousness, the corporation might eventually expel their own proud creations: consider the typical fate of the whistle-blower in even the well-managed corporation.<sup>5</sup>

## Changing the organization

If a corporation wishes to have a socially responsible board, what then can it do? It might consider a change in board structure. Another one? the reader may well ask. The board has been through many in this decade alone, not to mention the numerous mini-revolutions in board make up which have occurred during its history in this country. One aspect of the board's role has *not* changed, however: its status as the stockholders' representative. It is this role which, I propose, requires reexamination in light of the Panalba paradox.

## The traditional board role

When directors, behaving in response to their roles, commit what can be considered irresponsible acts, can we say that they are doing harm while *trying to do good*? A review of the empirical evidence, in particular the work of Milgram,<sup>6</sup> suggests that such is the case. The evidence is consistent with Charles A. Reich's view that today evil comes about not when people defy their duty, but when they do it.<sup>7</sup> What is the key duty of today's corporate director? How could its fulfillment lead to anything but good?

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administered successive amounts of shock to other subjects, supposedly randomly selected as “learners” (actually, they were actors). Under direct orders from an authority figure (a man in a white coat), they upped the voltage as the experiment “required.” *When told that they would not be held personally liable for their actions*, many of them upped the voltage to a supposedly intolerable level. In some cases the teacher thought they had killed their subjects.

<sup>4</sup> Raymond Baumhart, *Ethics in Business* (New York: Holt, Rhinehart and Winston, 1968).

<sup>5</sup> Robert Heilbroner, et al. *In the Name of Profit* (Garden City, N.Y.: Doubleday, 1972); and Gordon H. Fitch and Charles B. Saunders, “Blowing the Whistle: The Limits of Obedience to the Organization,” *Business and Society Review* (Fall 1976), pp. 5-14.

<sup>6</sup> Cf. note 3.

<sup>7</sup> Charles A. Reich, “The Limits of Duty,” *The New Yorker*, 47 (1971), pp. 52-57.

## The Questionnaire

*We are honored to participate in the research of Dr. J. Scott Armstrong, Associate Professor of Marketing at the Wharton School. The following questionnaire represents a constant in Dr. Armstrong's noted studies of social responsibility in corporate direction. Dr. Armstrong administered this same questionnaire under another title over a period of several years in several countries. He and his co-workers supplemented this questionnaire with two kinds of role-play experiments: one in which each board member was asked to represent all corporate interest groups, the other in which each member was asked to represent a specific interest group. The results of Armstrong's research, published in 1977 in the Journal of Business Research, have led him to form certain conclusions, which we shall send to a*

*number of prominent corporate constituents, eliciting their comments.*

*In a future issue, we will publish Professor Armstrong's conclusions, along with the statements our panel has made about them. We will also tell you how you—as a group, and, with your express permission, as individuals—have answered the “Wondola” questionnaire.*

*We hope that you, as corporate leaders, will take the time to participate in this ongoing project. Your responses, more than those of perhaps any other identifiable group, can reveal much about the corporate decision making process which involves us all.*

*Thank you for your attention.*

*The Editors*

Assume that it is August 1969, and that International Drug Corporation (IDC) has called a special board meeting to discuss what should be done with the product known as “Wondola.”

Wondola is a “fixed-ratio” antibiotic sold by prescription. That is, it contains a combination of drugs. It has been highly successful. It now accounts for about 18 million dollars per year, which is 12 percent of IDC's gross income in the U.S. (and a greater percentage of net profits). Profits from foreign markets, where Wondola is marketed under a different name, are roughly comparable to those in the U. S.

Over the past 20 years numerous medical scientists (e.g., members of the American Medical Association's Council on Drugs) have objected to the sale of most fixed-ratio drugs. Their argument has been that (1) there is no evidence that these fixed-ratio drugs have improved benefits over single drugs, and (2) the possibility of detrimental side effects, including death, is at least doubled. For example, these scientists have estimated that Wondola is causing about 14 to 22 unnecessary deaths per year — i.e., deaths which could be prevented if the patients had used a substitute made by a competitor of IDC. Despite these recommendations to remove fixed-ratio drugs from the market, doctors have continued to use them. They offer a shotgun approach for the doctor who is unsure of his diagnosis.

Recently a National Research Council panel of the National Academy of Science, a group of impartial scientists, carried out extensive research studies and recommended unanimously that the Food and Drug Administration (FDA) ban the sale of Wondola. One of the members of the panel was quoted by the press as saying, “There are few instances in medicine when so many experts have agreed unanimously and without reservation” (about banning Wondola). This view was typical of comments made by other members of the panel. In fact, it was typical of comments which had been made about fixed-ratio drugs over the past 20 years. These impartial experts then believe that while all drugs have the possibility of side effects, the costs associated with Wondola far exceed the possible benefits of those from Wondola, and yet they have no serious side effects. The selling price of the substitutes is approximately the same as the price for Wondola.

IDC's Special Board Meeting has arisen out of an emergency situation. The FDA told IDC that it plans to ban Wondola in the U.S. and wants to give IDC time for a final appeal to them. Should the ban become effective, IDC would have to stop all sales of Wondola and attempt to remove inventories from the market. IDC has no close substitute for Wondola, so consumers will switch to close substitutes which are easily available from other firms. Some of these substitutes offer benefits which are equivalent to those from Wondola, and yet they have no serious side effects. The selling price of the substitutes is approximately the same as the price for Wondola.

It is extremely unlikely that bad publicity from this case would have any significant effect upon the long-term profits of other products made by IDC. The following possible solutions were considered by the board:

a. Recall Wondola immediately and destroy.

- a. Recall Wondola immediately and destroy.
- b. Stop production of Wondola immediately but allow what has been made to be sold.
- c. Stop all advertising and promotion of Wondola but provide it to doctors who request it.
- d. Continue efforts to market Wondola most effectively until its sale is actually banned.
- e. Continue efforts to market Wondola most effectively and take legal, political, and other necessary actions to prevent the authorities from banning Wondola.

The members of the board must reach a decision at today's meeting. The Chairman of the Board has provided the above-mentioned background information to each of the board members.

Now consider the following questions:

1. If you were chairman of the board at IDC, what decision would you have made: a, b, c, d, or e? (Indicate the answer closest to your opinion.)
2. Assume that IDC selected decision e in this case. In your opinion, did IDC act
  - in a socially responsible manner?
  - in a socially irresponsible manner?
  - no opinion. (Indicate the answer closest to your opinion.)
3. How would you define a "socially irresponsible act"?

The U.S. legal system has advocated a "stockholder representative" role for directors since the early days of board organization in this country.<sup>8</sup> Summarizing this tradition, Eugene Rostow asserted twenty years ago, "The law books have always said that the board of directors owes a single-minded duty of unswerving loyalty to the stockholders, and only to the stockholders."<sup>9</sup> A decade ago Phillip Blumberg reviewed legal trends to find little change in the primacy of stockholder interests. The American Bar Association's Section on Corporation, Business, and Banking Laws, in its *Corporate Director's Guidebook*,<sup>10</sup> reveals that there is nothing new in this stockholder-centered board universe.

But a hard business-sense case can be made against an exclusively stockholder-oriented board of directors. The follow-up *Directors & Boards* questionnaire stated that in the 1920s some leading

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<sup>8</sup> See Joseph A. Joyce, "Directors of Corporations," *The Central Law Journal* (October 24, 1884), pp. 327-30, rep. in *Directors & Boards* (Summer 1979), pp. 51-57; and Thomas Cochran, "Adjusting to Bigness, 1890-1930," *100 Years of American Business* (New York: Dell, 1978), pp. 113-72, esp. pp. 168-69, on "Changes in Aspects of Major Control," about the history of director/stockholder relations during that period.

For an application of the fiduciary duty concept to the manager role, see the Berle-Dodd exchange in the following texts:

Berle, A.A. "Corporate Powers as Powers in Trust," *Harvard Law Review*, 44 (1931), pp. 1049-1074.

\_\_\_\_\_. "For Whom Corporate Managers are Trustees," *Harvard Law Review*, 45 (1932), pp. 1365-1372.

\_\_\_\_\_. "Foreword in Edward S. Mason, *The Corporation in Modern Society* (Cambridge, MA: Harvard University Press, 1959).

Dodd, E. Merrick, Jr., "For Whom are Corporate Managers Trustees?" *Harvard Law Review*, 45 (1932), pp. 1145-1163

\_\_\_\_\_. "Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?" *University of Chicago Law Review*, No. 2 (1935), pp. 194-207.

See also Abram Chayes, "The Modern Corporation and the Rule of Law," in Edward S. Mason, ed., *The Corporation in Modern Society* (Cambridge, MA: Harvard University Press, 1959), and Christopher D. Stone, *Where the Law Ends: The Social Control of Corporate Behavior* (New York: Harper & Row, 1975).

<sup>9</sup> "To Whom and for What Ends Is Corporate Management Responsible?" in Edward S. Mason, ed., *The Corporation in Modern Society* (Cambridge, Mass.: Harvard University Press, 1959).

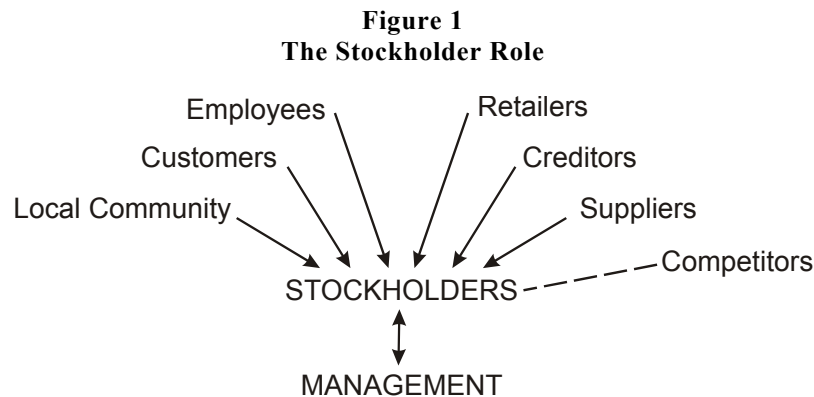
<sup>10</sup> Reprinted in *Business Lawyer* (Jan. 1978), pp. 1591-1644, and in the "Director's Update," *Directors & Boards* (Spring 1978), pp. 41-60.

businessmen called for a change in the role of the manager-director [cf. footnote 14]. Instead of representing only one party (e.g., the stockholder), he should represent all of the stakeholders in an organization (employees, local community, suppliers, stockholders, creditors, and retailers). The stockholder representative role advocates that directors make decisions so as to maximize returns to the stockholder. Many critics of the traditional representative role of the board have pointed to the negative impact it can have outside the strictly profit-oriented business realm on issues such as environmental pollution, employee rights, and product safety. I propose that in serving stockholders' interests alone, directors may also be contributing to the weakening of both individual companies and the free marketplace in which they operate. Consider an all-too-well-known example from the merger field: the unfriendly takeover attempt. Such attempts often yield substantial stockholder rewards in terms of price offered for shares at the time of purchase. But something there is that doesn't love a raid. What is it? Loyalty to management employees? To consumers? One could say that the sagas of McGraw-Hill and Houghton Mifflin were filled with such considerations.

On a more general, economic level, some decisions which benefit the stockholder can actually weaken the free-enterprise system. Increase in the imperfections of the market can also increase stockholder dividends in the triumphant corporations. When entry of new competitors is restricted, the famous "tacit" collusion among oligopolistic competitors grows, and consumer free choice is restricted. The stockholder may win in these cases – but at a high price to the free market.<sup>11</sup>

### The "stakeholder" theory

Assume that groups *a*, *b*, and *c* find themselves involved in a single undertaking in which each group's input is necessary for satisfactory performance. Now, for whom does the system really exist – for *a*? for *b*? for *c*? One cannot answer this query as it stands. But when *a*, *b*, and *c* are labeled as stockholder, employee, and customer, the situation comes to life and we can answer the question-or think we can. Tradition has taught us to see this system as stockholder-centered, as in Figure 1.



The favoring of one corporate constituency over another can harm the other constituencies if they have no recourse, as in the hypothetical "free-market" economy, to alternative corporate affiliations. In the "perfect" marketplace, unlimited possibilities for employment, purchases, etc. mitigate the harm a monistic constituency orientation can do. To take an example from the other end of the politico-economic world, the

<sup>11</sup> Cf. my article "The Manager's Dilemma: Role Conflict in Marketing," in George Fisk, et al., eds., *Future Directions for Marketing* (Cambridge, MA: Marketing Science Institute, 1978), pp. 78-89. It is interesting to note that a Council for a Competitive Economy has formed which argues in its promotional brochure that "many businessmen actually prefer not to operate in a free market." In demanding government protection in order to serve their stockholders, "business itself has become a threat to its own survival."



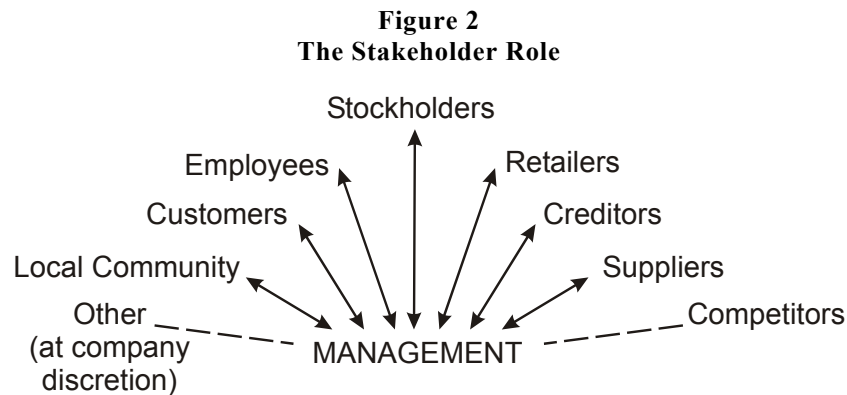
Yugoslavian economy favors wage-earners to the detriment of profit.<sup>12</sup> This exclusivity of corporate accountability would also be termed “irresponsible” in the pluralistic stakeholder theory.

To return to the contemporary corporate dilemma, how can companies see to it that their boards avoid harming the free-enterprise process? It is obvious that we cannot completely eradicate the imperfections of the market, but implementation of the stakeholder theory might reduce them. Other approaches to pluralizing corporate accountability include class action suits, exposes of irresponsible board actions, and strict product liability laws for both officers and directors.

This paper considers *yet* another approach. It shows how a corporation might change the director’s self-perception from that of a stockholder representative to one in which he views himself as responsible to *all* groups affected by the firm’s actions in a free-market economy. In this model, the director is considered a *stakeholder* representative.<sup>13</sup>

### Many masters

In contrast to the stockholder-representative role, or any other “suboptimization” approach, the stakeholder-representative role suggests that the director serve many masters. He or she is responsible to *a*, *b*, and *c*. A distinction is drawn, however, between primary and secondary interest groups. A primary stakeholder representative is affected by the decisions of the firm and also makes some contributions to it. A secondary stakeholder is affected by the firm’s decisions, but makes no direct contributions to it. An illustration of management’s relationship to the primary and secondary stockholders for a typical firm is presented in Figure 2. (The secondary stakeholders are designated by a dotted line.)



A board operating within the stakeholder role would try to ensure that the marginal rate of return on contributions to the firm is equal for each of the primary constituencies, while seeing that its actions wreak no unnecessary harm on its company’s competitors. Two-way arrows appear in Figure 2 to indicate that management should take the initiative in keeping the interest groups informed, and in seeing that they are adequately rewarded.

<sup>12</sup> Cf. Paul Blumberg, *Industrial Democracy: The Sociology of Participation* (New York: Schocken, 1968); and Jaroslav Vanek, *The Participatory Economy* (Ithaca, N.Y.: Cornell University Press, 1971).

<sup>13</sup> This attempt to change directors’ perceptions of their roles is consistent with one of the conclusions drawn from obedience studies: “Control the manner in which a man interprets his world, and you have gone a long way toward controlling his behavior.” Milgram, *op. cit.*, p. 143. This behaviorist phrase may send a chill through director-readers who, possessing a sense of free will in a free market, do not aspire to be controlled. The “control function,” however, is a classical management aspect of an enterprise, along with planning, coordinating, directing, etc. Directors both contribute to and are affected by this function.

Businessmen in the 1920s advocated a stakeholder role for the board. In 1929, Owen D. Young, Chairman of General Electric, argued that it was the duty of directors to see that the interest of each corporate constituency be fully recognized and protected.<sup>14</sup>

Frank M. Abrams, then Chairman of Standard Oil of New Jersey, advanced a similar idea in the *Harvard Business Review* in 1951. Recalling his thesis twenty years later, the *HBR* said that

It was Mr. Abrams' conviction that a company's duty is to serve as fairly and as equitably as it can the interest of four sometimes competing groups—owners, employees, customers, and the public ... Ideally they are all accommodated in major decisions and policies.<sup>15</sup>

The stakeholder theory advanced here advocates responsibility to all of the board's interest groups and to those interest groups alone. Each corporation must ascertain who its own constituencies are. The theory does not advocate that the manager act in the best interests of "society," a concept which, in its vagueness, may lead to arbitrary actions. If General Motors donated money to the University of Pennsylvania, its contribution would be responsible only if the university contributed to and/or was effected by the company's choices. The burden of proof would be upon the board to show that a particular charitable donation was a good "investment" for the primary stakeholders (if, for example, the University of Pennsylvania typically produced a number of engineers or research scientists who have done significant work for GM).

### **Is it possible?**

The law sees directors as stockholder representatives. Nothing short of a boardroom "campaign" for the stakeholder notion could change that. Is such a movement likely? Ralph Nader's attempt to encourage board representativeness, Campaign GM, only garnered 3 percent of the shareholders' votes.<sup>16</sup> Recent research, however, indicates that the attitudes of executives concerning their accountability are changing. This change might one day have an impact on their attitudes as directors. Surveys of *Harvard Business Review* readers have indicated that the notion of stakeholder representation is not alien to managerial attitudes of this decade. The *HBR* reported in 1971 that the majority – 61 percent – of respondents subscribe to the concept Frank Abrams set forth in the *HBR* in 1951.<sup>17</sup> A survey of *HBR* readers' sense of accountability in 1977 reveals that the executives who responded rank their constituencies in the following order of importance: customers, stockholders, employees, local community where company operates, society in general, suppliers, and government.<sup>18</sup>

This is what managers *say*, the reader might protest, but how would they act if they were actually assigned roles which champion the constituencies which they deem so vital to the corporate enterprise? My early Panalba research provides some answers. Keeping in mind the charge that rule by all would become rule by none – a challenge the above-cited Rostow aimed at the stakeholder debate in the late Fifties – we attempted to determine whether we could get the subjects which we had placed in *stockholder*-representative roles to change their voting patterns if they were placed in *stakeholder*-representative roles.

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<sup>14</sup> Howard R. Bowen, *Social Responsibilities of the Businessman* (New York: Harper Brothers, 1953), p. 49.

<sup>15</sup> David Ewing, "Who Wants Corporate Democracy," *Harvard Business Review*, 49 (Sept.-Oct. 1971), p. 146.

<sup>16</sup> Donald E. Schwartz, "The Public Interest Proxy Contest: Reflections on Campaign GM," *Michigan Law Review*, 69 (January 1971), pp. 419-538.

<sup>17</sup> Ewing, *op. cit.*

<sup>18</sup> Steven N. Brenner and Earl A. Molander, "Is the Ethics of Business Changing?" *Harvard Business Review*, 55 (Jan.-Feb., 1977), pp. 12-18, 146-49.

## Stakeholder role adopted

We used two different methods to introduce the stakeholder model into our experiments. One was to say that the board believed in the stakeholder role, appending the following statement to each subject's role description:

Finally, it is important to note that the members of the Upjohn Board had a number of discussions in the past as to the proper role that a board member should take. A resolution had been passed in 1950 which stated that the Board's duty was to recognize the interests of each and every one of its "interest groups" or "stakeholders." The stakeholders are those groups which make specific contributions to the firm. Thus, the board is to consider the effects of decisions upon employees, creditors, stockholders, customers, suppliers, distributors and the local community. Furthermore, the board should consider only its own stakeholders in making decisions. It shall not attempt to serve the common good or society in general. (All of the current board members are well aware of this policy statement.)

Note that these instructions did not command the subject to take on the stakeholder role, but merely stated that the board advocated such a role. Beyond this, the role descriptions were identical to those which described the traditional, Upjohn-like board.

The other set of instructions placed each board member in a particular stakeholder role. No single group dominated the board in this version of the experiment. The Chairman, President and stockholder represented were based on traditional models. In addition, however, there was one representative for each of the major constituencies a typical stakeholder board might recognize: employees, customers, suppliers, and local communities. In addition, each of the subjects in the stakeholder version was provided with findings from a "social accounting" of the various impacts the sale of the drug would have on all its corporate constituents. (See Table 1: the figures were created by the author to dramatize the extreme nature of this case.)

**Table 1**  
**Accounting Provided in Panalba Case: Estimated Losses (in Millions of Dollars)\***

<b>Alternatives</b>	<b>Stockholders</b>	<b>Customers</b>	<b>Employees</b>	<b>Total Losses</b>
	(1)	(2)	(3)	(1)+(2)+(3)
a. Recall immediately	20.0	0.0	2.0	22.0
b. Stop production	13.0	13.6	18	28.4
c. Stop promotion	12.0	16.8	1.2	30.0
d. Continue until banned	11.0	19.6	1.0	31.6
e. Prevent ban	4.0	33.8	0.2	39.0

\* These estimates represent present value losses to each group affected by this decision. The losses to customers represent deaths and illnesses caused by Panalba for which no compensation is received; losses to employees represent lost wages and moving expenses beyond those covered by severance pay and unemployment benefits.

If we consider *a* the best board choice, the second experiment can be termed successful. Its results are summarized in Table 2. Only 22 percent of the stakeholder groups selected choice *e* (vs. 79 percent of those placed in the traditional role), and 21 percent of the groups removed the drug from the market. (These results were statistically significant at  $p < .01$ ).

**Table 2**  
**Percentage of Groups Selecting Each Decision in the Panalba Case**

Tendency to support choice e	Traditional	Stakeholder Instruction	Democratic Board
High	76	23	22
Moderate	24	65	49
None	<u>0</u>	<u>12</u>	<u>29</u>
(Number of groups)	(41)	(57)	(59)

**The response of *D&B* readers**

In order to further my research on board responsibility and the stakeholder role, I published my questionnaire in the Winter 1979 issue of *Directors and Boards* and requested that readers respond. Later that year, the Editors followed up on the project by writing to some readers and prominent figures. Their responses are reprinted in the following pages. Reactions of readers varied. George Dillon, President and Chairman of Butler Manufacturing Company, seems to welcome the notion of a board which subscribes to the stakeholder theory. Dennis Livadas, a Rochester attorney, opposes it vehemently. Then there is David McLaughlin, CEO and Chairman of Toro Corporation, who asserts that questionnaire limitations cannot encompass such a complex issue. This might explain why the questionnaire attracted so few responses. Or perhaps readers did not respond because the stakeholder notion challenges us to actually *implement in the corporation* democratic values more easily cited than accomplished.

Finally, anthropologist Ashley Montagu replied, with another viewpoint on the issue of corporate responsibility, proposing yet other qualifications – and challenges – for the director:

Until we can restore education to its humanizing role, we are going to have a hard time recognizing that the best way to select corporate directors and managers would be on the basis of two primary qualifications: that they be first, loving persons, and second, intelligent enough to meet the challenges of each situation, as it arises, with the most appropriately successful response. Finally, the double standard of morality—one for business and another for the role-playing disguises of everyday life—must go.

If we could act in one consistent manner as loving and intelligent people, we would need no stakeholder board structure. As the human race stands now, however, the board must be designed in a way which promotes, intelligently and humanely, long-term economic good. The stakeholder-representative model might just fit that description.

## READER RESPONSES FOLLOW

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### Response to Reader Questionnaire

1. If you were chairman of the board at IDC, what decision would you have made, *a, b, c, d, or e*?

*a*

2. Assume that IDC selected decision *e* in this case. In your opinion, did IDC act

in a socially responsible manner?  
 in a socially irresponsible manner?  
 no opinion.

3. How would you define a “socially irresponsible act”?

*One that proves to be unethical or illegal.*

4. Dr. Armstrong states that:

According to previous studies, education will not lead to a reduction in socially irresponsible acts by corporate directors. Nor do we know how to select directors who are less likely to commit irresponsible acts. It seems likely then that some institutional change is needed. In the 1920s, some leading businessmen called for a change in the role of the manager-director. Instead of representing only one party (e.g., the stockholder), he should represent all the stakeholders in an organization [employees, local community, suppliers, stockholders, creditors, and retailers].

Do you think that corporations should be run “democratically” in this sense?

*Yes, in the sense that directors clearly have a responsibility to a corporation’s entire constituency and in many instances may have a legal liability.*

5. What is the likelihood that they will be?

*Much greater likelihood, and the change is already in process in many well-managed companies.*

George C. Dillon  
Chairman and President  
Butler Manufacturing Company  
Kansas City, MO

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To the Editors:

In response to your questionnaire:

1. I would have made a combined decision of *b* and *c*. I would have stopped production, advertising and promotion of Wondola immediately, but would have allowed what had been produced to be sold to doctors who requested it. For liability protection, I would have included a special warning about fixed-ratio drugs in a circular or on labels provided with the drug.
2. By selecting decision *e* they acted in a socially irresponsible manner.

3. The term “socially irresponsible act” has to be defined in relation to a specific set of facts. It is socially irresponsible to arbitrarily affect the earnings of the corporation to the detriment of the shareholders. However, it is more socially irresponsible to continue active efforts to market a drug which can take lives in the name of profits only. If the drug were sold under controlled conditions, shareholders could have a return on equity without endangering the lives of many otherwise unsuspecting individuals.
4. In answer to the first question, yes, I believe corporations should be run “democratically,” that director-managers should represent all of the stakeholders in an organization-employees, local community, suppliers, stockholders, creditors and retailers.

With respect to the second question, what is the likelihood that corporations will be run democratically, my answer would be, “diminishing all the time, but hopefully not irreversibly.”

The main consideration is not whether corporations will or won't be run democratically in the future, but rather what are the effects of their not having been run that way in the past. A good segment of the American public is disillusioned with both big and little business. This could create a very dangerous shift in the fundamental philosophy of the American public which may have devastating effects on our posterity. And that, coupled with the “free lunch” attitude fostered in the youth of America by our failing educational institutions, forebodes serious dangers for us all.

Thank you for the opportunity to participate in your research.

Charles E. Davis  
Law Offices of Udall, Shumway, Blackhurst, Allen, Bentley & Lyons, P.C.  
Mesa, Arizona

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To the Editors:

Responding to the “Wondola” questionnaire and story problem in the current issue of *Directors and Boards*, my recommendation as Chairman of IDC would unquestionably be *a* – to recall “Wondola” from the market immediately and destroy or dispose of the compound..

The biases underlying my response will be understandable, considering my position with the Michigan Cancer Foundation, but I thought it would be useful to you for your data to reflect at least one view from the non-profit sector, and from the health care sector specifically.

The assessment of social responsibility (or, in your framing of the question, irresponsibility) in a complex, technological society is a complex problem. In general, it might be said that action or behavior which is most consonant with or which better serves “the common good” (of the community, of society) is the more “socially responsible” action or behavior. It is equally true that in a free-enterprise economic system, it is only through the application of excess profits from the producing sector that projects and programs of social reform (i.e., programs to improve the commonweal) can find their support and their sustenance.

The making of profits, therefore, is not only socially responsible but is socially imperative in the kind of society in which we live, assuming that the activity from which these profits come does not violate other canons of the social contract to which both the producers and the consumers in the community subscribe. (Indeed, had you posed a problem in which IDC's sole source of income and profits was the sale of “Wondola,” the overall question of the company's response would be considerably stickier.)

The canon which any other but choice a would violate, in my view, is that members of a society should not be exposed to unnecessary or avoidable risks (physical, economic or psychological) in the pursuit of income and profits by any other members) of that society.

Some risks – or example, in administering experimental drugs, in taking up the sport of skiing – are in certain instances both necessary and unavoidable, but even in these situations, society (through its lawmakers) insists (1) that the risks be very clearly and comprehensively elucidated to those who are to be exposed to them, and (2) that those exposed specifically signify their consent to participate in the exposure.

The concept of “risk” is not an absolute one, and the data given in your story problem (i.e., that “Wondola” causes 14-22 deaths per year) are not sufficient to define the real hazard the drug presents. Only by knowing how many persons are exposed to “Wondola” each year, and then how many of these experience its dire effects, could one accurately assess the level of risk reasonably associable with exposure to the drug. One would also have to know, of course, the dosages at which the side effect is most pronounced and other variables of the victims’ environmental and biological status, in order to determine how isolatable – and therefore how avoidable – the risks inherent in the drug really are.

Complicating the issue of “Wondola’s” risk even further, the “common good” would not suffer substantially by the total withdrawal of the drug, for it is given that the public have access to close substitutes of comparable efficacy and considerably less inherent risk. Again, your problem would be considerably stickier were “Wondola” *sui generis* among those available in the pharmacopoeia.

In view of the epidemiological data, the findings of the FDA (however conservative that agency’s policies sometimes seem), the availability of adequate substitutes, and the presumably non-vital nature of “Wondola’s” contribution to IDC’s profit picture, there are, it seems to me, no compelling arguments for the company to consider any action except compliance with the FDA’s proposed ban, and good reason to conclude that any other choice would, under the circumstances, represent a “socially irresponsible act.”

Why do corporations continue, however, to behave in a way that others in society see as irresponsible, and how can the frequency of socially irresponsible acts by corporations be reduced?

Professor Armstrong suggests that since “we (do not) know how to select directors who are less likely to commit irresponsible acts,” some form of “institutional change” will be required. This is problematic, however, when one considers the essential synonymy between the “we” who select corporate directors and the “them” responsible for effecting changes in institutions. Institutions change only by changing their policy, and since policy is the prerogative solely of the directors, institutional change can only occur when the directors change, or when they change their mind. If we are indeed doomed to select “irresponsible” directors, then we are likewise doomed to an eternity of irresponsible corporate policy.

I doubt, however, that Professor Armstrong would contend that corporations today are significantly more socially irresponsible than they were, say, in the freewheeling, pre-Depression ‘20s. My own senses tell me that American corporations are steadily moving toward more pluralistic modes of policy decision-making, not necessarily because the “stockholder” role has become any less central, but because the “stakeholders” in American corporations have found ways other than the share-vote – including union actions, boycotts, injunctive relief, legislative appeals, community actions, newspaper campaigns – to influence corporate decisions/

These have all had the effect of making corporate decision makers ever more aware of, and vulnerable to, other interests and power modalities within the social structure. There may be a social “law” to the effect that a corporation will behave as irresponsibly vis-à-vis

the society as its community allows it to behave, but if this is the case, then its behavior can hardly be called a crime. I think American society is asking more and more of its corporations, and by and large, I think we are getting it.

I would hope that the real-life progenitor of the Wondola case put forward by Dr. Armstrong (the Panalba case involving the Upjohn Company) represents a waning trend, especially in those industries whose actions and products touch the health of the species.

Edward Shaw  
Director of Planning and Program Development  
Meyer L. Prentis Cancer Center  
110 E. Warren Avenue  
Detroit, Michigan 48201

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To the Editors:

I have your letter to Mr. Ford requesting a response to questions on corporate social responsibility.

The Board of Directors of Ford Motor Company formally addressed this issue in its "Statement of Corporate Purpose" published in the *1978 Annual Report*. I have enclosed a copy for your information.

T. P. Rhoades, Jr.  
Stockholder Relations Department Ford Motor Company  
Dearborn, Michigan

#### *STATEMENT OF CORPORATE PURPOSE*

Ford Motor Company is in business to create profits for its owners by serving the automotive, agricultural and communications needs of the worldwide society.

We seek to meet those needs by developing, building and marketing products that are fully responsive to the public's requirements for utility, safety, economy and high value.

We have a responsibility also to design our products in such a way as to provide for efficient use of energy and raw materials and for the protection of our natural environment.

We believe that Ford employees have a right to decent working conditions, good compensation and the opportunity for advancement on the basis of individual merit. Our doors are open to men and women alike without discrimination and without regard to ethnic origin or personal beliefs.

The Company does not stand alone in fulfilling its purposes. We are dependent upon thousands of other businesses throughout the world-independent dealers who market our products at retail and firms of all sizes that supply us with essential materials and services. Our relationships with dealers and suppliers alike are based upon mutual interest and respect and a recognition of the interdependence that binds us together and creates an even greater force for economic good.

Although Ford Motor Company was founded in the United States where it maintains its corporate headquarters, it is in fact a worldwide enterprise with subsidiaries, branches and affiliates in many countries. We subscribe to the principle of free trade on equal terms among all nations. As corporate citizens, we look to the governments of those countries in which we operate to permit free expression of our views on issues that concern our business. We refrain from involvement in purely



political matters, but participate openly in the process of government within the limits allowed by law and custom.

Both as a private corporation with a handful of owners and, more recently, as a publicly owned corporation with more than 350,000 shareholders, Ford Motor Company has prospered wherever free market conditions prevail. We believe strongly in the competitive system and are convinced that the public, worldwide, is best served when competitive forces are at work in the marketplace.

Beyond its purely economic interests, Ford Motor Company recognizes a need to work for the advancement of human welfare in all societies. It provides continuing support of a wide variety of educational, work training, cultural, civic improvement and charitable programs aimed at enriching human life. It seeks to expand opportunities for self-help and economic independence among those who can contribute much to their own societies and to the world at large.

Philip Caldwell  
President and Vice Chairman of the Board

Henry Ford II  
Chairman of the Board

William C. Ford  
Chairman of the Executive Committee

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To The Editors:

In response to your questionnaire:

Question 1. I would have marked choice *d*. The product cannot be condemned on the basis of an ad hoc "say so." While remaining open to proof, management should continue to market the product.

Question 2. I would deem IDC's decision "socially responsible."

Question 3. In the context of "Wondola," social irresponsibility would begin with intense and continued marketing after the FDA, having examined competent research, had reliably verified the accusations.

The final questions require a response in essay form, to wit:

Conventional political wisdom holds that a government owes its form and quality to the concerns and experiences of the society it governs. So too with economic systems: the institutions they contain develop naturally out of the trade and business needs of their constituencies. If people get the government they deserve, they get the business methods they create.

From the same national ethos that governs the republic, the business corporation evolved; and the status and powers of the latter's directors closely resemble the position of the former's policy-makers. They all rest solidly on long-developed traditions of representation, enterprising competition, continuity, majority rule, and orderly procedures under prescribed powers subject to periodic accountability and review, all according to law. Directors, at their peril, have to show good results for their stewardship, i.e., innovation, quality, productivity, marketing, and profits. The commitment to obtain these must precede other decisions. If the company is to survive, its directors must have the power not only to debate but to decide, and to decide on matters which will optimize "results."

So it may be unwise, as well as unfair, to charge today's directors with "social irresponsibility" simply because they are doing their job right. The words "social

irresponsibility” portray profit-seeking directors as blameworthy per se. For this reason it is perhaps their detractors who could be called irresponsible.

In our categorically specialized socioeconomic society, directors are supposed to monitor corporate activities with profit in mind, and the government is supposed to protect the public from their possible “mistakes.” Let each do its own job. Neither is equipped to do the other’s work.

In our carefully balanced politico-legal system of sophisticated rights, powers, duties, and liabilities, the director’s position and actions are minutely prescribed; there are too many prescribers looking over directors’ shoulders for them to indulge in personal sympathies.

Directors must be recruited from the same backgrounds from which they have traditionally been drafted (business, law, accounting). These types have served us well. Why change?

Dennis J. Livadas  
Attorney at Law  
800 East Avenue  
Rochester, N.Y. 14607

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To the Editors:

While I respect the objectives of your recent survey to define corporate attitudes and positions on corporate responsibility decision making, we have decided to abstain from responding, for we do not believe that complicated situations such as the Wondola case depicts are subject to simplistic answers. Our own experience indicates that a manager would need considerably more information about the nature of the problem and the environment in which it exists before reaching any conclusion on the course of action to be taken.

I wish you every success in the future with your publication, and while I regret that we cannot be more helpful to you on this project, we continue to admire the fine service which *Directors and Boards* provides the business community.

David T McLaughlin  
CEO and Chairman  
The Toro Company  
Minneapolis, Minnesota

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It is important to recognize that we have very little, if any, [democracy] in the Western World. What we have is “instruction,” a training in techniques and skills devoted to achievement of “success,” in a society in which the “successful” (in terms of external validations) end up by becoming the victors who belong to the spoils. “Education” (from *educare*, to nourish and to cause to grow) should mean the art and science of being a successful human being, one who is able to relate himself to others in a creatively enlarging manner; one who lives as a healthy human being, which means through the ability to love, to work, to play, and to use one's mind soundly; one who lives as if to live and love were one. Until we can restore education to its humanizing role we are going to have a hard time recognizing that the best way to select corporate directors and managers would be on the basis of two primary qualifications: first, as a loving person, and second, as one who is intelligent enough to meet the challenges of

each situation as it arises with the most appropriately successful response. Finally, the double standard of morality – one for business, and another for the role-playing disguises of everyday life – must go.

Ashley Montagu