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Stone: Where the Law Ends: The Social Control of Corporate Behavior

Steven R. Hirschtick

BOOK REVIEW

THE CONSCIENCE OF A CORPORATION

WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR. By Christopher D. Stone. Harper and Row. New York 1975. Pp. xiii, 273. $12.95.

*by Steven R. Hirschtick**

A corporation is not subject to the same moral responsibilities which affect us all. As a separate entity, it feels no guilt for actions that would universally be considered wrong, for example, the marketing of a harmful drug following the suppression of test results indicating that drug's potential effect. Moreover, the major corporations, which are our "private governments," have been known to abuse their concentrations of wealth and power. Yet the United States Supreme Court has declared that corporations are among the "persons" who are entitled to due process and equal protection benefits under the Constitution.[1] The evolution of our legal system based, in part, upon this status for corporations has resulted in a scheme which does not recognize the institutional peculiarities of a large corporate structure. However, corporate abuses have led to many calls for a corporate social responsibility independent of, but supplementary to, the corporation's legal responsibilities. Others, however, have concluded that the responsibility of corporations should be limited to obedience to the law.

In his new book, *Where the Law Ends,* Christopher D. Stone argues that a lack of corporate social responsibility is insufficient. He attacks the premise that if corporations are not acting responsibly, then corrective legislation should be passed, as it would be in the case of any individual. Furthermore, he also disagrees with the position that corporations should merely be required to comply with these laws; beyond the laws, however, the corporations would be free to act. Stone's major

* B.S., 1968 (University of Illinois); J.D., 1971 (University of Illinois); Member, California State Bar; Member, Illinois State Bar; Professor of Law, Loyola of Los Angeles Law School.

1. Kentucky Fin. Corp. v. Paramount Auto Exch. Corp., 262 U.S. 544, 550 (1922).

premise is that the law is not working and we therefore need corporate social responsibility, rather than the converse advanced by many that corporate social responsibility is not workable and instead we need more law. His work is not a vague call for social responsibility; it is a non-technical treatise written logically and supported throughout by case citations and illustrations. The first half of Stone's book is devoted to a brief history of the development of corporate law in our society and an analysis of why that law is not working to produce a more favorable result. The latter half contains his ideas for change, many of which will seem to some, upon first reading, radical and unthinkable. In his clear and logical style, Stone anticipates most of the criticism of his proposals and presents a convincing position that his proposals are in fact necessary and reasonable.

Stone's work begins with a discussion of the development of corporate law. The corporation cannot act as an individual; rather, it must act through individuals acting on its behalf. Our early legal system was geared to operating upon individuals, and it was not until the early 17th century, when this system had already evolved, that corporations began exerting their own identities as actors. With the industrial revolution, there came a dramatic increase in the number of corporate charters which were issued. State legislators developed flexible corporate codes in furtherance of their "charter mongering," brought on in part by a desire to increase state revenues by increasing the number of corporations chartered in a particular state. Broad judicial opinions interpreting already flexible corporate codes occurred at the same time that the corporate structures were growing and becoming more complex. Corporations were involved in the same activity as individuals, yet distinctions between the two types of actors existed. For example, a corporation could not be imprisoned for the same wrongful conduct which would cause the imprisonment of an individual. Furthermore, the shareholders of the corporation were protected from individual liability in most cases by the so-called corporate veil of limited liability. In short, the legal system did not and has not to an effective degree recognized the institutional peculiarities of a corporation and has merely brought the corporation into the system as a "person." Following this brief account of corporate legal history, Stone asks the questions of what do we want our law to accomplish and whether the current scheme is achieving that goal.

Stone concludes that the primary functions of law are a distributive function (of risks and losses) and a function of reducing certain harm-

ful behavior. He divides this harmful behavior into absolutely harmful, and therefore absolutely prohibited, and qualifiedly harmful, which may be eliminated after a balancing of the benefits of elimination versus costs of elimination. The problem is, however, that the law is directed to the effect of a wrongful act and not to the act's source, *i.e.*, the institutional weakness that led to the particular act. Why not apply the law to subject key corporate individuals to criminal and civil sanctions? The corporation itself certainly cannot be imprisoned. In theory, these sanctions are available against the responsible individuals in the corporate structure; the difficulty is in determining the identity of these individuals. Many of Stone's proposals consist of expanding and defining the informational net within the corporate structure, and therefore ascertaining the identity of the individuals directly responsible for the acts of the corporation.

In Stone's opinion, there are other reasons why the law is not working. Many of the current sanctions imposed for wrongful corporate conduct are based upon a "rational economic person" concept—the corporation is based upon profit maximization and therefore penalties which are directed to the corporation's pocketbook will produce the desired conduct. Stone challenges this concept and argues that factors other than profits, *e.g.*, prestige, are at work in the institutional structure. Furthermore, the law is only a small part of the whole range of marketplace considerations affecting the corporate decision-making process, and is not a substantial part of a corporate subsystem's (individual profit center) reality. Yet it is this subsystem that is responsible for initiating or facilitating many of the actions for which the corporation is eventually faulted. For example, an individual profit center, defining success on its level and not the corporate level, may not transmit negative information up the ladder to higher level decision-makers for a variety of reasons, including a desire to protect superiors or avoid displeasing them. The law, however, focuses on the corporate level and not on each of the subunits.

Another reason cited by Stone for the law's failure to accomplish the desired result is the separation of management and ownership in large corporations. The shareholders are usually a diffuse group, and in most cases have acquired their interests over a stock exchange rather than by direct investment in the corporation. When a fine is imposed upon such a corporation, it affects the corporation, but does not directly affect the management which was responsible for the decision. Stone was not aware of any evidence pointing to an ouster of management

because of such situations.[2] In smaller (close) corporations, the decision is one of noncompliance versus cost of compliance, but the shareholders, whose identity is closer to management in a close corporation, are protected by the corporate shield of liability.

One arguably possible solution would be to increase the fines for certain disfavored conduct. Stone's reaction to this suggestion is:

> I do not mean to suggest that the shift to bad-bargain strategy [increasing penalties and fines] in selected areas is not possible, or even likely. But there is, I think something of a theorem we must recognize, that our *counter-organizational measures will always be skewed toward fair-bargain strategy and away from bad-bargain strategy*, more so in the case of a corporation than of the human being. That is, we will incline to make the punishment "fit the crime" in the sense of collecting damages, or depriving the corporation of its unjust enrichment—its ill-got gains—rather than make it "fit the crime" in the more severe sense of making the action a dreaded risk in the future.
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> Thus, the overall picture is that our strategies aimed to control corporations by threatening their profits are a very limited way of bringing about the internal changes that are necessary if the policies behind the law are to be effectuated.[3]

Further, Stone concludes that measures aimed at individual wrongdoers are also not working for a variety of reasons. Plaintiffs aim for the deep pockets of the corporation rather than the individuals, and even when there is an attempt to impose sanctions against the individuals, a plaintiff or prosecutor is confronted with the requirement of demonstrating that individual's responsibility. This is no easy hurdle to overcome given the screening process of bad news that occurs within the corporate structure and the court's willingness to allow ignorance to insulate corporate management. Furthermore, in many cases where liability could be successfully imposed upon responsible individuals, the existence of liability insurance or indemnification by the corporation will reduce the impact of the sanction.[4] In Stone's words:

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2. Such evidence is indeed scarce and difficult to find, *but see Morality Play: Gulf Officers' Ouster was Boldly Engineered by Mellon Interests*, Wall Street Journal, Jan. 15, 1976, at 1.

3. C. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR, 57 (1975) [hereinafter cited as C. STONE].

4. California has in fact just liberalized (from management's point of view) its officer and director indemnification provision. Law of Sept. 12, 1975, ch. 682, § 7, ¶ 317, [1975] Cal. Stat. — (effective January 1, 1977) [hereinafter cited as GEN'L CORP. LAW]. Amendments have been made to the General Corporation Law prior to its

> In any social grouping, it is doubtful how effective legal threats can be as an instrument of social change, especially when the behavior to be changed has "customary" support within the group, involves means condoned (or at least not strongly condemned) by the larger community, and does not result in injuries that the individual actors can clearly and vividly connect with their own behavior.[5]

Having concluded that the law is not working, Stone does not immediately proceed with his suggested solutions; rather, he challenges those who have argued that corporations' sole obligations relate to their agreements with their shareholders regarding the maximization of profits. Stone acknowledges that the anti-responsibility arguments are based upon the corporations' alleged inability to be equipped for anything other than operating by the dictates of the marketplace within the constraints of law. He asks why shouldn't corporations be responsible and interprets the promise to shareholders regarding profits not to mean profits "in every way possible" without regard to any moral framework. Stone faults the "anti's" not for their position, but for not pursuing the alternatives. For a number of reasons, including the consumer's ignorance of injury and ignorance of any power to correct a wrong which is perceived, the marketplace is not the appropriate forum for correcting the existing wrongs. Furthermore, the law as currently structured is not doing the job, and probably cannot be restructured in a manner which would be effective without changing the thrust of the current system, insofar as the current system fails to draw a distinction between the the "morality of duty and the morality of aspiration." That distinction is that the law may prohibit certain conduct, but it cannot penalize an individual for failing to work to his greatest potential.

There is, of course, as Stone recognizes, the problem of defining responsibility. It is easy to say that a corporation must act responsibly, but it is considerably more difficult to decide what that responsibility shall mean. Does it mean merely that corporations should adhere to the applicable codes, or does it mean that a corporation should act only after it has thoroughly reflected upon its capacity for choice and the impact of its actions? The former definition is the one currently in vogue in the corporation codes, and, by this point in his book, Stone has already concluded that this concept is not working. Most of his

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effective date by the enactment of A.B. 2849, Reg. Sess. (1975-76), Law of Aug. 27, 1976, ch. 641, [1975] Cal. Stat. — [hereinafter cited as Technical Amendments Bill]. Amendments will be reflected in this review.

5. C. STONE, *supra* note 3, at 67.

proposals are based upon the latter definition of responsibility and a focus upon the corporations' decision-making process. In short, he is focusing more upon how the corporation does what it does rather than upon the end result of the decision-making process. It is his belief that the redesigning of the decision-making process will achieve the desired result with respect to the corporation's actions.

Not all of Stone's proposals are improvements on (or intrusions into, depending upon your outlook) the corporations' decision-making process. The first element of his all-encompassing proposals is a reformation of the Board of Directors. This element is founded upon the proposition that there are certain issues relating to corporate conduct (*e.g.*, the marketing of a drug with grievous side effects) upon which the public and a cross-section of informed business persons would not disagree. He then proposes a board structure which should eliminate wrongful conduct regarding these issues. Specifically, he proposes the elimination of inside directors and the increase in the number of financially disinterested directors on the board. Furthermore, the board's specific functions should be detailed and standards for directors' liability should be set forth. Part of the proposal includes increasing the information flow to the directors and their newly created staffs and thereby making it easier to trace responsibility within the organization.

The foregoing is by no means the full extent of Stone's proposals. He further suggests that the largest corporations must include general public directors on their boards. These directors would be appointed by a newly created Federal Corporations Commission, and the number of any such general public directors would be determined by the sales or assets of the corporation. Stone's proposal would only include the largest corporations (262 companies based upon Fortune's 1973 listings). The general public directors would work half-time with the assistance of a staff, and would have nine primary functions which would include acting as a super-ego of the corporation, checking on compliance with the law, and providing a hot line for any "whistle-blower" who perceived a problem within the corporation.

If one accepts all of Stone's premises and arguments to this point, then the general public directorships would logically follow. The only fault that can be found with this concept is the scope and magnitude of what the general public directors are being asked to accomplish. Stone recognizes this and states:

> When one gets right down to it, if the *only* virtue of the general public directorship system was the symbolic one—a more obtrusive, nagging

> reminder of these companies' obligations to society than the American flag over their plants—the system would, to my mind, have justified itself.[6]

The general public directors would not be expected to discharge all of their functions or work in highly critical areas of their corporation. Nor would the general public directors be available for smaller corporations who were also having difficulties in interacting with their environment. To remedy these situations, Stone proposes special public directors. These special directors would be appointed by courts or agencies to work in critical areas of social concern for corporations which have demonstrated their delinquency through repeated violations or for corporations in an industry which was suffering a problem (*e.g.*, the health of workers in the asbestos industry). This concept is not as foreign as it may at first sound. Provisions already exist for court appointed special directors in certain problem situations.[7] These problem situations, however, relate only to the shareholder-corporation relationship and not to the corporation's relationship with its environment. Stone further supports his special public director concept by a discussion of cases in which courts have done almost the same thing under a different label.

Stone's suggested reforms go well beyond the board level. Noting that "only men admitted to the Bar can appear for a corporation in court, but anyone it [the corporation] chooses can evaluate its laboratory data,"[8] Stone proposes the creation of certain specific offices (*e.g.*, a vice-president for environmental affairs of a company operating in a heavily polluting industry). Stone further states:

> Once the law establishes job definitions for critical offices, then liabilities should be attached for the inadequate performance of those functions. The point is central to the theme of this entire book: As corporations increase in size, and production processes become more complex, and more and more persons (and machines) have a hand in the finished product, it is increasingly difficult to locate responsibility on any one particular individual *for that end product*: the defective car or the building that collapses. But if we make a system of punishments *task*-oriented (in addition to our *product*-oriented punishments), it is much easier to locate responsibility—on the person who failed to per-

6. *Id.* at 174.

7. A provisional director may be appointed by the court to break a board deadlock. CAL. CORP. CODE ANN. § 819 (West 1955), *continued without change in* GEN'L. CORP. LAW, *supra* note 4, § 308, *as amended*, Technical Amendments Bill, *supra* note 4, § 9.

8. C. STONE, *supra* note 3, at 193.

> form the critical task—and thus to head off problems before they occur.[9]

The most innovative (or most intrusive) of Stone's proposals consists of sensitizing the corporation to the impact of its actions. The corporation's informational net should be amended and reconstructed to provide a more complete gathering of information from the environment. Rather than the creation of firm rules by governmental agencies and the confrontations which ofttimes follow, Stone proposes that specific decision-making persons should be designated within the corporate structure and that these individuals should be responsible for the preparation of impact reports. The corporation should be required to receive information through hearings and other means and, based upon this information, to prepare an impact study for all of its significant actions, similar to the environmental impact reports which are already required. The benefits of such a procedure are that the corporation is formally required to justify its actions and thereby required to devote significant thought to those actions. The corporation may sometimes come up with the wrong answer, but at least it will be asking the right questions. Moreover, the anonymity by which responsibility is often avoided under our current rules would be removed.

With respect to all of his proposals, Stone recognizes that so long as the underlying attitudes of the current corporate culture continue to exist, then the effectiveness of his suggestions will be reduced. To remedy this, he suggests certain proposals (*e.g.*, in-house education programs and social audits, among others) as attempts to alter these attitudes.

Stone does not discuss the governmental level upon which his proposals should be implemented. These proposals, at least those requiring governmental action, if implemented on a state level would result in the same type of forum shopping by corporations and charter-mongering by some states which Stone initially faulted. This result could be avoided by requiring compliance with a state's corporations code for all corporations, domestic or foreign, which were transacting business within that state. This is the approach taken in the new California General Corporation Law.[10] The other solution would be the creation

9. *Id.* at 190.

10. GEN'L CORP. LAW, *supra* note 4, §§ 2100-16, *as amended*, Technical Amendments Bill, *supra* note 4, §§ 30.2-.32

of a federal corporations code, a proposal currently being advanced.[11]

Professor Stone's work constitutes a complete and well thought-out blueprint for corporate reform. Credibility is lent to each of his suggestions by his willingness to admit and discuss possible shortcomings. His suggestions are based upon recognition of a corporation's organizational attributes and interaction with corporations on that basis. These proposals and his concepts of social responsibility will no doubt become integral parts of any future discussions of this topic. His proposals represent concrete suggestions in an area where it has always been easier to state the problems than to suggest workable solutions. In sum, whether one views his proposals as innovative solutions to existing problems or unthinkable intrusions into the corporate structure, his book will provide an education and much food for thought on the topic.

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11. *See, e.g.*, Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAWYER 1101 (1974).