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# An Analysis of Corporate Governance Reforms Proposed in Response to *Citizens United* to Limit Corporate Political Spending

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## Introduction

In the much discussed *Citizens United v. FEC* case, the Supreme Court overturned existing prohibitions on corporate political expenditures and recognized that outright prohibitions on corporate political spending, on the basis of the speaker's legal status as a corporation, violate the first amendment rights of corporations as legal persons.[1] The opinion was a strong reaffirmation of the status and rights of the corporation.

One of the government's arguments in defending the political restrictions at issue was that the restrictions served to protect shareholders from abuse of corporate money by corporate executives.[2] The Court's response was to suggest that any problems could be corrected through the "procedures of corporate democracy," though the Court did not suggest which procedures would be most useful in that regard.[3]

The Court noted that shareholders dissatisfied with a company's illicit spending could also bring private derivative actions to recover the amounts spent from individual board members or executive officers.[4] It should also be noted that shareholders have the right under state corporate law to bring Section 220 actions, essentially exploratory actions based on a hint of mismanagement that are subject to a very low evidentiary threshold and under which shareholders can demand business records from the corporation.[5]

> "This report argues that there are a number of reasons to be skeptical of corporate governance responses to Citizens United."

The Court noted that modern technology makes disclosures about corporate political spending already required in other regulatory areas rapid and informative.[6] Though the majority opinion in *Citizens* referenced the procedures of corporate democracy, it did not argue that those procedures should be changed. This report argues that there are a number of reasons to be skeptical of corporate governance responses to *Citizens United*.

Though the language in *Citizens United* about corporate democracy did not advocate changing the corporate election system or the disclosure system for publicly traded securities, and indeed referred

1 See Carol Herdman, *Citizens United: Strengthening the First Amendment in American Elections*, 39 Cap. U. L. Rev 723 (2011).
2 See Herdman at 742.
3 *Citizens United v. Federal Election Com'n,* 130 S.Ct. 876, 911 (U.S. 2010)
4 See Stephen A. Yoder, *Legislative Intervention in Corporate Governance Is Not A Necessary Response to Citizens United v. Federal Election Commission*, 29 J. L. Com. 1 (2010).
5 See Delaware General Corporation Law Section 202. See also *Thomas & Betts Corp. v. Leviton Manufacturing Co., Inc.,* 685 A. 2d 702 (Del. Ch. 1995).
6 See Yoder at 11

to the status quo in both areas, opponents of the opinion have seized upon that reference to urge amendment to the federal rules governing shareholder voting and corporate disclosure to investors to make it more difficult for corporations to engage in political spending.[7] The proposals at issue all relate to publicly traded corporations registered with the SEC and whose stock is traded on public exchanges like the NYSE. This report will consider how those proposals fit into the existing machinery of the shareholder voting process, the securities disclosure laws, and indeed the very purpose of the corporate form of business organization. It will also consider the potential they might have to damage the attributes of the corporation that have served to make it such an important driver of economic growth.

"Shareholder participation in corporate political expenditures is neither necessary nor sufficient to address concerns about corruption."

Shareholders have two available remedies if they become dissatisfied with the performance of their companies. Shareholders can sell their shares, or they can vote for an alternative nominee in the next annual election of the Board. They do both with some frequency. If their concern is founded in a violation of the federal securities laws or involves a breach of duty by the board, shareholders can also file suit.

In the rare event that political advocacy actually crosses the line and becomes corruption, there is a third line of defense in place. The Foreign Corrupt Practices Act (the "FCPA"), which applies to all publicly traded companies, originally prohibited bribery of solely foreign officials.[8] It was amended in 1998 to also prohibit bribery of government officials in the United States by foreign companies. Additionally, bribery has long been prohibited under various other state and federal laws. For example, the federal bribery statute prohibits an individual or company from giving or promising anything of value to a public official with the intent to influence an official act.[9] This calls into question arguments by some proponents of regulating corporate political expenditures through corporate governance reforms that corporate participation in the political system will lead to public corruption.

Shareholder participation in corporate political expenditures is neither necessary nor sufficient to address concerns about corruption, particularly when compared against the current FCPA regulatory regime in place. The unique function of the FCPA is that is doesn't merely provide penalties for bribery, but also requires publicly traded firms to establish extensive accounting and auditing proce-

7 See H.R. 4790, The Shareholder Protection Act of 2010, available at http://www.govtrack.us/congress/bill.xpd?bill=h111-4790. See also Ciara Torres-Spelliscy, Corporate Campaign Spending: Giving Shareholders A Voice, Report of the Brennan Center for Justice, available at http://www.brennancenter.org/content/resource/corporate_campaign_spending_giving_shareholders_a_voice/.

8 For a summary of the FCPA, see http://www.justice.gov/criminal/fraud/fcpa/.

9 See 18 U.S.C. Section 201.

dures designed to prevent and catch bribery by employees. The accounting and auditing procedures required under the FCPA would limit employees from any payments "off the books," whether to US or to foreign officials. Further, CEOs and CFOs are required to certify that they have established robust internal controls to catch violations of accounting rules which are accompanied by strict potential 25 year jail sentences under the Sarbanes-Oxley Act of 2003.[10]

"Those that stand to suffer the most from the proposals under consideration are ordinary main street shareholders who hold shares through their 401(k)s."

Thus we see that the response to *Citizens United* is not motivated by a desire to expose wrongdoing or to stop corruption – robust tools already exist to deal with those concerns. In order to understand the motivation behind this reform movement, it is important to appreciate the nature of share ownership. There are two types of shareholders in American publicly traded companies. The first are retail investors, or ordinary Americans holding shares individually or through retirement funds and 401(k)s. More than half of all American households own stocks in this way. The other broad type of investor is the institutional investor, including union pension funds as well as state pension funds run by elected officials. Looking at ownership of publicly traded securities broadly by type of owner, individuals hold directly roughly 36% of outstanding securities, private pension funds hold roughly 8%, state pension funds hold roughly 7.5%, and mutual funds hold around 20%.[11] State and private pension funds however have much higher voting rates than is seen among individual investors because the former are required to vote under ERISA retirement fund regulations where the latter are not required to vote their shares.

The corporate governance reforms that have been proposed seek to give those institutional investors that typically have highly politicized objectives leverage over companies for political purposes at the expense of retail investors. The holding in *Citizens United* applied equally to corporations and unions.[12] The new corporate governance based restrictions will not apply equally to both groups, but targets only companies and will work to give unions a significant advantage over corporations on issues where their viewpoints differ. The primary reason is that, where shareholder referenda are required on corporate political expenditures, a large bloc of the shareholders voting will be union pension funds and other state pension funds that frequently vote with unions. These funds have demonstrated a market propensity to alter their votes based on political considerations. For instance, one study demonstrated that holding all other variables constant, the presence of union-represented

10 See 18 U.S.C. Section 1348. See also SEC Exchange Act Rule 13(b).

11 See Federal Reserve Board of Governors, Flow of Funds Accounts of the United States, available at http://www.federalreserve.gov/releases/z1/current/z1.pdf.

12 See Richard A. Epstein, *Citizens United v. FEC: The Constitutional Right that Big Corporations Should Have But Do Not Want*, 34 Harv. J. L. & Pub. Pol'y 639 (2011).

labor at a company can change the voting behavior of union pension funds in a company election. [13]

We have seen numerous instances where institutional shareholders use their leverage to achieve political goals, like the California Pension Fund's insistence on environmental or health policy changes paid for by ordinary shareholders. The one group with the most to gain from the corporate governance reforms that have been proposed is large institutional shareholders that have unique conflicts of interest. Those that stand to suffer the most from the proposals under consideration are ordinary main street shareholders who hold shares through their 401(k)s. The ultimate goal of these reforms is to contort the securities laws to regulate campaign finance. This risks impeding the investor protection purpose of the securities laws and limiting the ability of companies to communicate with legislators by giving special interest institutional shareholders, such as unions, power to stop those communications.

## II. The Essential Role of Centralized Corporate Authority in the American Economy

Corporations are a legal innovation created to allow business ventures to continue absent the control or life of a single investor. Corporations can allow large groups of people to invest in projects who may not otherwise be able to do so. Even where one individual could own an entire company, the range of company investments available allow that individual to instead diversify their risk across a portfolio of corporate investments. The standard corporation is characterized by four distinct characteristics: an entity with legal personhood that has indefinite life, limited liability of the individual investors for corporate obligations, free transferability of shares, and centralized management who are appointed by equity investors.[14]

These four attributes have led some to call the corporation one of the most important innovations in the modern economy. It allows investors to invest without fear of liability in large-scale enterprises that they do not possess the time or ability to oversee. It also allows for more efficient management through a single chain of command. The free transferability of shares, which does not require dissolution of the business every time the company's shares change hands, allows large-scale ownership and thereby large-scale operations. This allows most ordinary Americans to participate in the potential of companies like McDonalds or Microsoft, thereby growing their retirement savings faster on average than if they were relegated to bonds or certificates of deposit. It also allows companies to more easily obtain financing without having to agree to the fixed payments of bank loans.

Many trace the evolution of the modern corporation to the various corporations established by the English King, such as the East India Tea Company.[15] One of the earliest commentaries on the Eng-

13 See Ashwini Agrawal, Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting, July 2010, available at http://ssrn.com/abstract=1285084.

14 See Robert Charles Clark, Corporate Law 4-24 (1986).

15 See Reuven S. Avi-Yonah, *Citizens United and the Corporate Form*, 2010 Wis. L. Rev. 999, 1002 (2010).

lish common law described them as "artificial persons, who may maintain a perpetual succession, and enjoy a kind of legal immortality" and that when its owners "are consolidated and united into a corporation, they and their successors are then considered as one person in law: as one person, they have one will…for all the individual members from the foundation to the present time, or that shall ever hereafter exist, are but one person in law, a person that never dies…"[16] The earliest examples from England and the American colonies required that an arm of the government, either the King, the Parliament or the local legislature, establish the corporation through legislative charter. The process later evolved to make it much simpler and easier to establish corporations, and after the revolution the rush of trade and commercial development gave birth to an explosion of corporate charters in all the free colonies.[17] Limited liability for shareholders has been a key feature of the American corporation since the 1830s.[18]

Corporations are treated as legal persons in many respects, both in terms of the rights they are given and the obligations they are held to. They can sue in court and can be sued. They can be convicted of criminal acts. They can participate in the democratic process. They are required to pay taxes. They can own land. They can enter into contracts with people or with other corporations. Legal personhood is the key to the corporation's indefinite life, transferability, and ability to scale to large projects. Since it can enter into contracts in its own name, it does not have to renegotiate them every time the CEO is replaced or the investors change.

## III. Federal Regulation of the Corporate Voting Process

Corporate law gives shareholders the power to vote for elections to the Board of Directors, and it gives them the power to vote on mergers of the company in which the shareholders stake will be permanently bought out. Other than those items, it has not traditionally left matters of ordinary corporate policy up to shareholder vote.

One of the reforms that critics of the *Citizens United* ruling have advocated is enhanced disclosure of corporate political spending under the federal securities laws.[19] Still another is mandatory shareholder voting to approve political expenditures by corporations. These reforms are typically advocated with reference to corruption and abuse of office.[20] The reforms suggested would be fairly irrelevant when considered next to the other mechanisms that prevent corrupt or illegal political expenditures. Even post-*Citizens United*, companies are prohibited from illicit political activity. Company directors and officers owe fiduciary duties of loyalty and care to their shareholders, and any action violating federal or state law can subject the board members and officers of a company to

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16 See Avi-Yonah, citing 1 William Blackstone, Commentaries at 455.
17 See Avi-Yonah at 1003.
18 See Avi-Yonah at 1008.
19 See Ciara Torres-Spelliscy, *Corporate Campaign Spending: Giving Shareholders A Voice*, Report of the Brennan Center for Justice.
20 See id.

liability under state corporate law for violating those duties.[21] Furthermore, companies are required to institute internal compliance programs to monitor their employees to make certain that they are following the law.[22]

Requiring a shareholder referendum on all expenditures would cripple corporate decision-making. Companies have to consider thousands of expenditures of the size at issue in the debate over corporate political expenditures. The corporate form is innovative precisely because it allows extensive delegation of decision-making to professional managers. Shareholders have neither the time nor the expertise to become involved in the day-to-day operating decisions of the company. Shareholder referenda on political expenditures are a dangerous step toward unraveling the necessary attributes that have made corporations such effective engines of economic growth since they were first developed.

Further, a lack of shareholder participation in corporate decision-making is one of the justifications for allowing shareholders limited liability from the company's liabilities. Legal liability is grounded on the principle that liability should go hand in hand with control. The thinking goes that if we hold those responsible who could have prevented harm, we will incentivize more caution from all responsible parties in the future. Where shareholders become more actively engaged in day-to-day decisions like political expenditures, the underpinning for limited liability will be placed in jeopardy. If that happens, companies will face nearly insurmountable hurdles in raising capital through sale of public equity as individual investors will fear becoming personally and jointly liable for the actions of companies in which they invest.

A key feature of the American system of corporate governance is the principle of federalism. States create corporations under corporate codes. States further compete for new incorporations, and to obtain re-incorporations from other states, to obtain franchise tax revenue. The market for incorporation is fluid, since companies do not actually have to re-locate their physical operations to change their state of incorporation. This gives the various state governments an incentive to innovate their codes in ways that maximize value for companies and their shareholders. The competitive nature of the corporate governance system has been described as the "genius of American corporate law."[23] This competition is however completely absent at the federal level, where the SEC enjoys a monopoly on regulating the securities markets. The corporate governance proposals responding to *Citizens United* that have been put forward all involve new initiatives by the SEC, and would therefore damage state competition in corporate law and endanger the benefits of state competition in developing American corporate law. The initiatives proposed involve either forced disclosure by the SEC, legislative proposals requiring shareholder approval of expenditures using proxy laws administered by the SEC, or SEC policy changes in the way it interprets the propriety of shareholder proposals for inclusion in the corporate proxy to make it easier for groups of shareholders to put proposals forward.

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21 See, e.g., *Miller v. AT&T*, 507 F. 2d 759 (3rd. Cir. 1974).

22 See *In Re Caremark International Inc.*, 698 A.2d 959 (Del. Ch. 1996). See also Section 404 of the Sarbanes-Oxley Act of 2002.

23 See Roberta Romano, *The Genius of American Corporate Law*, AEI Press (January 1, 1993).

## IV. Corporate Political Spending

The debate over corporate political spending has become characterized by the assumption that it is inherently bad, that in some way political expression by individuals through other organizations to which they pay dues, or to which they might belong or own an equity interest, such as privately held companies, unions, or condominium associations are somehow different. There is an underlying assumption among critics of corporate participation in the democratic process that company participation will undermine the process itself.

When corporations engage with elected officials and political appointees they can advocate on behalf of the collective property interests of their shareholder owners in a way that the individual shareholder owners may not otherwise have the time or ability to accomplish. For example, General Electric and AT&T both spend a great deal of corporate resources developing energy and telecommunications products, both of which are highly regulated industries. They are also subject to extensive private rights of action under federal statutes that allow trial lawyers to sue them for extensive damages. Individual attorneys and attorney advocacy groups are not targeted by the latest post-*Citizens United* reform efforts, yet these companies clearly are targeted. One of the effects of corporate governance based restrictions on corporate political spending will be to give tremendous advantage in favor of the trial lawyers who might target companies in advocating for changes to these laws. Without an ability to counter the political advocacy of these powerful groups, shareholders could be harmed by the very laws that purport to have their interests at heart.

One of the arguments that advocates of limiting corporate political spending have raised is that it may infringe on the free speech rights of shareholders who do not agree with their corporation's spending strategy.[24] And yet any shareholder dissatisfied with a company's policy can freely sell their shares. If the securities laws require shareholder input for an immaterial expense like political contributions, then it would also be required for other expenses of a similar nature. Corporate charitable giving represents an immaterial expense at the individual company level, but in the aggregate represents nearly 10% of all charitable giving, or roughly 10 billion in annual charitable giving in the United States.[25] For that matter, if immaterial expenditures require shareholder vote then other material expenses like health care plans for employees, decisions about where to put new plants (overseas or in a particular state), and decisions about new lines of business can all have an expressive and political dimension that would require shareholder referenda under the same logic. Shareholder votes over these decisions would cripple the corporate form and impede economic growth.

Limits on shareholder participation in corporate policy decisions allow for more effective and efficient decision-making. A leading corporate legal scholar, Professor Bainbridge, has explored the social and economic foundations for granting discretion to the board of directors to make broad corporate policy decisions. Shareholders have the ability to vote for alternative candidates for the

24 See Brennan Center Report at 10.

25 See Alan Ferrell and Victor Brudney, *Corporate Charitable Giving*, 69 U. Chi. L. Rev. 1191 (2002).

board of directors and to sell their shares easily and quickly, both of which allow for quick expression of shareholder sentiment without the need for complex decision-making and potentially nonsensical outcomes.

Managers and the board of directors have substantial discretion to decide how to spend money, but that discretion is bounded by corporate law. Members of the board and managers have a fiduciary duty to the company and its shareholders not to waste corporate assets. One significant power shareholders have in policing abuse of corporate assets is the power to bring derivative actions against executives and members of the board of directors to address corporate wastes. Just like in any litigation, there are gateway mechanisms to prevent lawsuit abuse. Some have argued that those mechanisms mean that shareholder lawsuits are an ineffective means to police such abuses. To the contrary, shareholders have certainly been able to successfully navigate past those mechanisms by sufficiently alleging evidence to support wrong-doing, like waste of corporate assets, executive compensation irregularities, or conflicts of interest.[26] For example, shareholders challenging executive compensation expenditures at Citigroup were able to sufficiently allege the expenditures constitute a waste of corporate assets sufficient to survive a motion to dismiss.[27]

## V. Analysis of Proposed Reform to Require Shareholder Votes on Corporate Political Expenditures

One of the reforms proposed in response to *Citizens United* is to give shareholders a vote on corporate political expenditures. This suggestion should be considered in light of an existing and ongoing debate about giving more power to shareholders to oversee decisions by the company's board and its managers.

Supporters of giving more power to shareholders of public companies argue that it could help to police management excesses and improve company performance. That idyllic description fails to appreciate the complexities of company ownership. For example, many shareholders do not vote, or inform themselves about the voting process, out of rational apathy owing to a low proportionate benefit or their slim odds of affecting the outcome.[28] That rational apathy is more likely to be true for retail shareholders interested in maximizing their investment, and who are at the same time trying to diversify their portfolio. But for institutional investors, like union pension funds who often vote out of political motivations rather than to maximize the value of their shares, rational apathy

26 See e.g., *In re Citigroup Inc. Shareholder Derivative Litigation*, No. 3338-CC, 2009 WL 481906 (Del. Ch. Feb. 24, 2009).

27 See id.

28 For more background on the discussion in this and the succeeding three paragraphs, See J.W. Verret, *Defending Against Federal Proxy Access, Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. Corp. L. 391, 447 (Winter 2011), Citing Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. L. & Econ. 395 (1983) (arguing that stale legal rules establish favorable voting arrangements for shareholders).

may not hold as much force.[29]

The leading critique of the current voting system comes from Lucian Bebchuk, who argues that the current system, in which incumbents are financed by the company and insurgents are not, results in higher agency costs and challenges the legitimacy of the deferential approach of corporate law in giving substantial discretion to managers.[30] In support of his thesis that annual elections are a largely empty exercise, Bebchuk notes that during the period of 1996-2005 there were only eight contested elections with rival slates among companies with a market capitalization of over $200 million. Bebchuk argues that part of the reason for this odd result is the required cost of filing proxy statements, risk of legal liability, and solicitation costs. Stephen Bainbridge offers what has become the leading criticism of Bebchuk's view.[31] Bainbridge considers the board of directors to be a guardian for the nexus of contracts that make up the corporation. In effect, his theory accepts shareholder wealth maximization as the ultimate driving goal, but his theory justifies placing the responsibility for managerial oversight with the board of directors of the company. He builds on literature explaining the existence and function of firms to show that the command and control function of firms is a vital solution to collective action constraints facing shareholders. Bainbridge also supports the idea that most of the parties to contracts with the firm, including shareholders, can withhold their capital as a mechanism for protecting their interest.

Another line of thought focuses a defense of board discretion on the conflicts between different groups of shareholders.[32] Anabtawi catalogues the costs that would result from empowering a group of shareholders seeking to advance their own private interests at the expense of the shareholder collective, including the distortionary effects on managerial decision-making and the costs of influencing managers. Romano also lists some of the conflicts facing state and union pensions, including the pressure to maximize in-state employment and push for "socially responsible policies."[33] Though

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29 See, e.g., Bernard S. Black, *Next Steps in Proxy Reform,* 18 J. Corp. L. 1, 4-8 (1992) (stating that passivity of shareholders, including institutional investors, is inescapable and serves each shareholder's interest even if active monitoring better serves shareholders as a whole).

30 See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 676(2007) ("Shareholder franchise does not provide the solid foundation for the legitimacy of directorial power that it is supposed to supply.").

31 See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 550-51(2003).

32 Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561, 564 (2006). Other commentators have also focused on the potential for conflicts and drawbacks to empowering particular institutional shareholders. See Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 Bus. Law. 67, 78(2003) (questioning whether institutional invetors have the resources or expertise to monitor managerial decisions). See also Jonathan Macey, *Too Many Notes and Not Enough Votes*: *Lucian Bebchuk and Emperor Jeseph II Kevetch About Contested Director Elections and Motzart's Seragio*, 93 Va. L. Rev. 759, 766(2007) (noting also that one of the difficulties with a proxy access regime will be the difficulty in recruiting competent candidates).

33 Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93

these conflicted institutions tend to vote quite regularly, by contrast mutual funds tend to be apathetic toward director elections and shareholder proposal votes.[34] In addition, large state pension funds are not required to give their beneficiaries any participation rights in decisions about political expenditures.[35] Finseth argues that the structure of public pension funds, in which beneficiaries have segregated investments managed by a fiduciary, are so similar to corporate ownership that to the extent public pension funds support shareholder approval of political expenditures they should also support referenda by fund beneficiaries on fund political expenditures.[36]

One of the costs to shareholder empowerment that Grundfest identifies is something he terms "megaphone externalities," which he uses to refer to a union or public pension fund's ability to use the corporate election as a way to raise the profile of an issue even though the fund knows it will not be successful.[37] Grundfest cites a confrontation between CalPERS and Safeway CEO Steve Burd as an example of shareholders using the corporate ballot as a vehicle for political objectives unrelated to the value of the company at issue. He describes how the President of CalPERS, the largest state pension fund in California, was also the head of the United Food and Commercial Workers Union. At the same time that the UFCW was engaged in a labor dispute with Safeway over the company's decision to cut worker benefits, CalPers decided to initiate a companion shareholder electoral challenge to oust the Safeway President.

Supporters of shareholder referenda on political giving have pointed to recent reforms in the United Kingdom that require a shareholder vote approving a company's annual political expense budget.[38] They argue, for example, that political budgets are almost always approved in the U.K.[39] But any comparison between the British experience and corporate governance reforms in America will be severely constrained. American companies typically have a large percentage of their shares held by politically motivated investors, like Union Pension Funds and state pension funds run by elected officials. In Britain, the institutional investors they typically see are insurance companies and private pensions managed by companies that are more focused on the bottom line. Shareholder votes in American companies are more likely to feature arguments about items that have little to do with shareholder value. Further, as companies and unions are often on opposite sides of various political debates, it is also likely that unions will seek to use new shareholder power to mute corporate opposition and gain an advantage in their own political outreach. Furthermore, if companies are required to obtain shareholder approval in advance of political expenditures, they will be confined to the pre-

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Colum. L. Rev. 795, 796(1993) (listing some of the conflicts facing state and union pensions, including the pressure to maximize in-state employment and push for "socially responsible policies").

34 See Eric John Finseth, *Shareholder Activism By Public Pension Funds and The Rights of Dissenting Employees Under the First Amendment*, 34 Harv. J. L. & Pub. Pol'y 289, 292 (2011).

35 See Finseth at 317-318.

36 See Finseth at 317.

37 See Joseph A. Grundfest, The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law, 65 Bus. Law. 361, 380-82(2010).

38 See Brennan Center Report at 16.

39 See Brennan Center Report at 18.

approved budget and will not be able to obtain additional approvals until the next annual meeting. Other items in annual budgets can require supplemental emergency funding to deal with problems that arise or capitalize on new opportunities, and companies have reporting lines in place to approve those supplemental expenditures and maintain a flexible budgetary response. Alternatively, companies put incentive schemes to give managerial bonuses to those who come in under budget to help them internalize the costs of going over-budget. If shareholder approval of a political expenditure budget is required in advance, companies will not be nearly as flexible as unions in designing their political engagement strategy. That result is likely an intended consequence that explains the interest of union pension funds in these types of proposals.

## VI. Analysis of Proposed Reform to Require Increased Disclosure in Company Financial Statements

One of the reform proposals put forward is to require companies to include extensive descriptions of their political expenditures in the financial statements that they file with the SEC. Such a change would be a substantial departure from the SEC's current reporting standard, which is centered on the notion of requiring only information that is material, or important, to investors in making a decision about whether to purchase or sell a security. Political expenditures are clearly immaterial at nearly every publicly traded company, with the typical example being political expenditures of a few million dollars at companies that have hundreds of millions in annual revenues and expenses. As evidence of the immateriality of political expenditures, only 14% of publicly traded firms made political contributions during the period from 1991 to 2004, and collectively all contributions by those hundreds of firms totaled only $100 million.[40] That figure includes soft money donations and donations to 527 Committees. In the second quarter of 2011, by contrast, corporate profits totaled roughly $1.93 trillion (or nearly $8 trillion annuitized). [41]

The SEC has acknowledged the usefulness of starting with a rule of thumb that financial items representing less than 5% of a company's revenues or expenses will typically not be considered material unless there is some evidence of fraudulent conduct.[42] Political expenditures would not exceed that amount at any publicly traded company.[43] The SEC does not accept any numerical threshold as definitive on the question of materiality however. They have provided guidance describing a number of instances that will also be considered "qualitatively" material even if they are not "quantitatively material," but none of those items would cover lawful political expenditures in pursuit of a company's

40 See Testimony of Ann Yerger of the Council of Institutional Investors, Hearing Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, United States House of Representatives March 11, 2010, "Corporate Governance After *Citizens United*."

41 See Bureau of Economic Analysis Report Report on National Income and Product Accounts, August 26, 2011, available at http://www.bea.gov/newsreleases/national/gdp/2011/gdp2q11_2nd.htm

42 See SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 19, 1999).

43 See Yoder at 20.

constitutionally protect right to free speech.[44]

One of the risks of disclosure in this context is that mandated disclosure of immaterial information will result in information overload. Material information can become difficult to interpret when hidden within the mounds of disclosure already required by the SEC, with corporate annual reports stretching into hundreds of pages. Further, disclosure isn't free, and compliance costs associated with disclosure requires weighing the costs and benefits of new regulations.

Many corporations are voluntarily disclosing their political spending. Recently 70 publicly traded companies voluntarily agreed to disclose their spending practices.[45] If shareholders actually do value this type of disclosure, then companies voluntarily disclosing should experience a price bump in their shares, in which case other companies will have an incentive to disclose as well. In any event, leaving the decision with companies about disclosure of information that is not obviously material will allow companies, who have the most information about the costs of disclosure, to make the most appropriate decision. Companies already have incentives to disclose information material to shareholders because it can result in increases in stock price and they are already incentivized against fraudulent or misleadingly incomplete disclosure because they may face the prospect of securities class action suits or SEC Enforcement investigations. Stock prices are very important to executives; since they are paid in stock options whose value is tied to share prices and since companies occasionally raise capital through new issuances of stock. Thus companies already compete to disclose more credible and useful information to shareholders even in the absence of disclosure mandates.[46]

But it may not be productive to disclose expenditures in all cases, and the board and managers of a particular company would be in the best position to determine whether disclosure is appropriate. Disclosure of corporate political expenditures could actually damage corporations. When it was

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44 See SEC Staff Accounting Bulletin, supra. Some of the items listed include: i) Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate, ii) Whether the misstatement masks a change in earnings or other trends; iii) Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise; iv) Whether the misstatement changes a loss into income or vice versa; v) Whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability; vi) Whether the misstatement affects the registrant's compliance with regulatory requirements; vii) Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements; viii) Whether the misstatement has the effect of increasing management's compensation-for example, by satisfying requirements for award of bonuses or other forms of incentive compensation; and ix) Whether the misstatement involves concealment of an unlawful transaction.

45 See Press Release, Center for Political Accountability, New Companies Bring Political Disclosure to Nearly Half of Trendsetting S&P 100., available at http://www.politicalaccountability.net/index.php?ht=a/GetDocumentAction/i/2636.

46 See Frank Easterbrook and Daniel Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

revealed that Target stores funded a business lobby group that supported a gubernatorial candidate who himself was opposed to gay marriage, Target was faced with a firestorm of criticism from a very vocal but small minority of its consumers that caused it to disengage from debates over business regulation important to its long term economic interests.[47] The cause of the controversy was expenditures to support a ballot initiative group. That group's work indirectly benefited a gubernatorial candidate who was also known for supporting gay marriage restrictions. The controversy caused a reaction despite the fact that Target and other donors had open employment practices and the ballot group did not participate in the issue directly.[48] Whole Foods faced a similar situation when its CEO expressed his personal views online about health care reform.[49] If political expenditures immaterial to investors, but which could harm the company's position with consumers or other groups, are mandated by new disclosure rules then the effect will be to harm the very shareholders the reforms are intended to protect.

Another proposal that advocates of corporate governance responses to *Citizens United* have put forward is requiring personal director liability for violations of these disclosure rules which may discourage risk-averse directors from approving or permitting any political expenditures by the company.[50] Yet companies must remain able to indemnify and insure the members of their board against personal liability for actions that, though taken in a good faith interest in helping the company, result in liability for regulatory sanction. Otherwise boards will struggle to recruit new members. The proposals advanced may also impede existing contracts between board members and companies to indemnify them for liability. Regulations require that a majority of the board be composed of independent directors who do not work for the company. The prospect of personal liability could limit board participation by high net worth corporate executives concerned about the safety of their assets and be of equal concern to lower net worth candidates unable to afford insurance coverage. Thus, it will become more difficult to recruit independent directors.

## VII. Shareholder Proposals

Some groups of shareholders have sought to use the shareholder proposal process to limit corporate flexibility in political expenditures. A company's bylaws govern the company and, if legal under state law, bind the board of directors to take or not take certain actions or to follow a particular process in approving certain actions. Bylaws can be adopted by majority vote of the shareholders, even over the objection of the board. But, state law vests substantial mandatory authority in the board of directors, and shareholder bylaws are not permitted to limit that mandatory authority.

For example, in Delaware, where over half of all publicly traded companies are incorporated, Section 141 of the state corporation law requires that the board "manage the business and affairs of the

47 See Epstein at 657-658.
48 See Bowie at 574.
49 See id.
50 See Brennan Center Report at 22.

corporation."[51] Shareholders can adopt bylaws that mandate board action, but only insofar as those bylaws do not limit board authority under 141. The Delaware Courts have defined the distinction as one of process vs. substance. Where a bylaw requires a certain board committee to make a decision, the bylaw is probably legal under 141. Where a bylaw requires a particular substantive business decision, such as a bylaw that mandates that the company invest in a certain business project, it would most certainly violate 141 and be considered null and void. Shareholders can finance their own voting solicitations to get other shareholders to approve of bylaw proposals, but that is highly expensive. Instead, the securities laws administered by the SEC provide an avenue for shareholders to place proposals, including bylaws, onto the proxy solicitation (essentially the corporate ballot) financed by the corporation under Rule 14a-8.

Most shareholders advancing proposals use this method, and in order not to run afoul of DGCL 141 they submit their proposals as recommendations rather than as mandatory requirements. There are a number of restrictions on use of 14a-8, including that the proposal i) violates state law ii) relates to ordinary business of the company, or iii) relates to procedures already implemented by the company.[52] One advocate of corporate governance reforms in the wake of the *Citizens United* case has urged that the SEC actually pre-empt state law to mandate that shareholders have the right to place bylaws requiring disclosure of political expenditures and requiring certain processes for approving those expenditures onto the corporate ballot.[53] The SEC rules on disputes between companies and shareholders about whether companies are required to include proposals in their proxy statements. In the wake of *Citizens United* a number of shareholder groups sought to use 14a-8 proposals to limit corporate political expenditures.[54]

A handful of recent rulings from the SEC relate to proposals concerning corporate political expenditures. One shareholder proposal at Wal-Mart Stores Inc. sought to request that the company describe its process for considering and approving political expenditures and explain the business rationale for particular expenditures.[55] Wal-Mart argued that the proposal related to the ordinary business of the company and should be excludable from its proxy statement, but the SEC did not agree and required that it be included on the proxy.[56] In the end, the proposal obtained little support, garnering only 12% of Wal-Mart shareholders in support.[57]

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51 See Delaware General Corporation Law Section 141.

52 See Martin P. Dunn, Keir D. Gumbs and David M. Lynn, Proxy Statement Developments, 1839 PLI/Corp 355, 358 (October 8, 2010) Practicing Law Institute.

53 See Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University School of Law, Hearing Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, United States House of Representatives March 11, 2010, "Corporate Governance After *Citizens United*." 1849 PLI/Corp 765.

54 See Ronald D. Orol, *Investor Groups Take Action In Wake of Citizens United Ruling*, MarketWatch (April 16, 2010), available at http://www.marketwatch.com/story/investors-take-action-after-citizens-united-ruling-2010-04-16.

55 See Dunn et. Al. at 369.

56 See Wal-Mart Stores, Inc., SEC No-Action Letter (Mar. 29, 2010).

57 See www.proxymonitor.org.

Shareholders at Home Depot won the right to place an election expense proposal onto the corporate ballot in a recent case. The proposal recommended disclosure of political expenditures and recommended that the company provide for a shareholder advisory vote on political expenditures.[58] The SEC staff has received other no-action requests that it has interpreted in the other direction and ruled that proposals requesting more disclosure about political expenditures about specific issues were part of the ordinary business of the company and that the company could exclude them from its ballot.[59] The SEC permitted Bristol-Meyers Squibb to exclude a proposal from its ballot requiring disclosure of its lobbying activities in connection with the passage of Medicare Part D because such lobbying went directly to products sold by the company and therefore formed part of its ordinary business operations. More widespread political expenditure and lobbying disclosure proposals have survived SEC scrutiny under the 14a-8 process. The SEC's No-Action interpretations on controversial issues typically vacillate between positions, particularly depending on the party of the President who appointed its Chairman.[60] For now, it appears that the SEC will generally permit shareholder proposals recommending enhanced disclosure of political expenditures.

During last year's proxy season, proposals to require supplemental disclosure of corporate political expenditures were submitted at roughly 75 companies.[61] Many of those proposals were pro forma proposals developed by the Center for Public Accountability. The CPA version asks for the names of officers involved in the decision and applies to any expenditures designed to influence an election. Others took aim directly at company funding to the US Chamber of Commerce and to ballot initiatives.

## VIII. Shareholder Response

The overwhelming majority of shareholder proposals on corporate political expenditures have failed to receive a majority vote. Typical shareholder support for political expenditure proposals averages around 30%.[62] At a handful of companies, like Target, the proposals were withdrawn after the company agreed to a compromise.[63] Though the proposals would not be binding even if they were to pass, the inability of corporate governance reform advocates to obtain a majority vote demonstrates that most shareholders remain skeptical of their value. In 2010, proposals to increase disclosure on corporate political donations went up for a vote at 30 companies. The average result was a 71.3% vote against the resolution. [64]

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58 See Home Depot Inc., SEC No-Action Letter (Mar. 25, 2011); available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2011/northstarasset032511-14a8.pdf

59 See Bristol-Myers Squibb Company, 2009 SEC No-Act. LEXIS 590 (Feb. 17, 2009).

60 See, e.g., Coffee at 799.

61 See Carol Bowie, Corporate Social Issues: A 2011 Proxy Season Preview. 966 PLI/Tax 549 Practicing Law Institute, April 19, 2011.

62 See Yerger at 7.

63 See, e.g., SEC No Action Letter, In re Target, 2011 WL 462954.

64 See Bowie at 573.

If shareholders found the right to vote on corporate policy to be a valuable exercise, we should imagine that companies that allow greater shareholder participation to experience higher average shareholder returns. In fact, there is a consensus in the empirical literature that, with the exception of a debate over the effect of policy proposals completely unrelated to political expenditures, shareholder votes on corporate policy suggestions do not result in increased shareholder returns. [65]

When large banks issue debt to companies, they are very adept at writing clauses into the debt indentures that restrict corporate activity that the bank considers harmful to their interest. For example, banks typically include provisions that require immediate repayment of debt when the company's working capital falls below a certain threshold or when a new shareholder seizes control of the company.[66] Debt holders have been fairly disinterested in corporate political giving in the wake of *Citizens United* and have not sought to include provisions in new debt issues limiting corporate political expenditures. This adds further evidence to the argument that corporate political expenditures are an immaterial expense.

## Conclusion

The structure of American corporate law rests the authority to manage the day-to-day affairs of the company, including decisions of how to invest the company's funds, with the Board of Directors. Putting corporate expenditures to a shareholder vote and requiring disclosures of immaterial expenses is the first step toward turning shareholder votes into town hall meetings. Some shareholders may want the company to locate a new factory in their town or give away free health benefits for employees without regard to whether the expenses risk bankrupting the company. Shareholders choose the board of directors and delegate authority to make these decisions to the board in order to avoid that very problem.

The Supreme Court recently affirmed that corporations have a constitutional right to advocate on behalf of their shareholders. Corporations do so particularly to protect the property rights of those shareholders from expenses associated with regulations whose benefits may exceed their cost. Many reputable companies spend money for this purpose. Berkshire Hathaway, one of the most highly regarded companies in America, spent $3 million dollars last year advocating for the interests of the company and its shareholders.

The corporate governance reforms proposed in the wake of *Citizens United* threaten to impede on corporate free speech rights by an alternate route to the one overturned in the case. They also threaten to impede the efficient growth and function of American publicly traded companies.

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65 See Gillan and Starks, The Evolution of Shareholder Activism in the United States, Journal of Applied Corporate Finance 19, 2007 (citing various studies)

66 See Jennifer Arlen and Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 University of Pennsylvania Law Review 577 (2003).

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