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CORPORATE LAW CONSTRAINTS ON POLITICAL SPENDING

BY JAMES KWAK*

I. INTRODUCTION

In 2008 and 2009, a financial panic nearly crippled the global economy and plunged the United States into the most severe economic downturn since the Great Depression, costing over eight million jobs. In June 2009, the administration of President Barack Obama announced its proposals to reform the financial system that had made this crisis possible.¹ One of its central recommendations was the creation of the Consumer Financial Protection Agency (CFPA), a new regulator devoted to protecting ordinary people from the risks presented by financial products such as mortgages and credit cards.² The CFPA was deeply unpopular with many businesses, particularly the financial institutions who created and sold the products that the Agency was supposed to protect consumers from. The fight against the CFPA was led by the U.S. Chamber of Commerce, a lobbying and advocacy organization that claims to represent the interests of over three million businesses.³ The Chamber spent millions of dollars on an advertising campaign attempting to demonize the Agency and helped organize the opposition under the banner “Stop the CFPA.”⁴ After the Consumer

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1. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

2. See generally *id.* at 55–63.

3. About the U.S. Chamber of Commerce, U.S. CHAMBER OF COMMERCE, <http://www.uschamber.com/about> (last visited May 20, 2013).

4. Brody Mullins, *Chamber Ad Campaign Targets Consumer Agency*, WALL ST. J., Sept. 8, 2009, <http://online.wsj.com/article/SB125236911298191113.html>.

Financial Protection Bureau⁵ (CFPB) was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),⁶ the Chamber has continued lobbying to weaken the Bureau and opposed the appointment of its first director.⁷

So far, so good: the Chamber of Commerce is an interest group, like many other interest groups, that has the right and the ability to advocate for its preferred policies. The Chamber and its political activities, however, are funded by contributions from member companies, many of which (and the largest of which) are public corporations. The Chamber takes positions on a wide range of political issues, not just financial regulation. Some of its positions probably could be characterized as generically “pro-business,” such as its support for infrastructure investment.⁸ Some, however, tend to favor some sectors of the business community over others, such as its support for free-trade policies.⁹ And some have little to do with the health of American businesses and more to do with the distribution of the surplus generated by those businesses, such as its positions on individual income tax rates.¹⁰ In short, many of the Chamber’s activities are not necessarily in the interests of each of the corporations that fund those activities.

Those corporations are owned by their shareholders and, in principle, ultimately governed by and for the benefit of those shareholders. In theory, therefore, they should not be spending money to support policies that do not provide value to their true owners. In

5. The administration originally proposed to call this new agency the Consumer Financial Protection Agency. The agency that was eventually created by the Dodd-Frank Act, however, is named the Consumer Financial Protection Bureau.

6. Pub. L. No. 11-203, 124 Stat. 1376 (codified in scattered sections of the U.S. Code).

7. Press Release, U.S. Chamber of Commerce, U.S. Chamber Expresses Disappointment in Move to Advance CFPB Director Nomination (Oct. 6, 2011), *available at* <http://www.uschamber.com/press/releases/2011/october/us-chamber-expresses-disappointment-move-advance-cfpb-director-nominatio>.

8. *See Reliable and Secure Infrastructure*, U.S. CHAMBER OF COMMERCE, <http://www.uschamber.com/infrastructure> (last visited May 20, 2013). Still, one could argue that the use of taxpayer dollars to pay for domestic physical infrastructure is not in the interests of corporations that make relatively little use of that physical infrastructure, either because of the nature of their operations or because much of their operations are located in other countries.

9. *See International Trade and Investment*, U.S. CHAMBER OF COMMERCE, <http://www.uschamber.com/trade> (last visited May 20, 2013).

10. *Individual Taxes*, U.S. CHAMBER OF COMMERCE, <http://www.uschamber.com/issues/econtax/bush-tax-cuts> (last visited May 20, 2013).

practice, however, decisions to support particular political organizations and causes are generally made by company executives, occasionally with oversight by the board of directors, but without meaningful input from shareholders. Contributions to the Chamber and to similar organizations are a way for directors and officers to use corporate assets to influence the political process in ways that may or may not benefit their shareholders.

The issue for shareholders is how to ensure that their corporations' political activities are actually in the interest of shareholders. This is a particular example of the central question of corporate governance: how to ensure that the actions taken by directors and officers are good for shareholders. Governance of corporate political activity has become particularly salient since the Supreme Court's 2010 decision in *Citizens United v. Federal Election Commission*,¹¹ which, along with the D.C. Circuit's subsequent decision in *SpeechNow.org v. Federal Election Commission*,¹² made possible unlimited corporate contributions to "independent expenditure committees" that do not contribute to or coordinate their activities with political candidates. These judicial decisions significantly increased the potential volume and impact of corporate political activity, raising the stakes for shareholders who are concerned about misuse of corporate funds for extraneous political purposes.

This paper asks how, if at all, existing corporate law ensures that corporate insiders only engage in political activity that benefits the corporation and therefore its owners. Shareholders have certain tools to influence corporate actions before they occur, including the ability to elect directors and to vote on particular proposals included on a corporation's proxy statement. Because these tools give them little control over a corporation's political activities, I focus on their principal remaining lever: a derivative lawsuit challenging political spending that is allegedly harmful to the corporation. I argue that shareholders can challenge corporate political expenditures in court and that courts should carefully scrutinize those expenditures to ensure that they are not tainted by a conflict of interest and that there are reasonable grounds for believing that they are in the best interest of the corporation.

Part II of this paper briefly describes the types of political

11. 558 U.S. 310 (2010).

12. 599 F.3d 686 (D.C. Cir. 2010).

expenditures available to corporations and the legal issues raised by corporate political activity.¹³ Part III summarizes the duties owed to shareholders by directors and officers under existing corporate law.¹⁴ In Part IV, I discuss how these duties should be applied to corporate political expenditures.¹⁵ Part V addresses the particular questions raised by contributions to charitable organizations that engage in political activity.¹⁶ Part VI discusses whether the arguments of this paper raise any First Amendment issues regarding the freedom of speech of corporations.¹⁷ Part VII concludes by comparing heightened judicial scrutiny of political activity to other reforms that have been proposed recently.¹⁸

II. CORPORATE POLITICAL ACTIVITY

A. Options

Corporations may attempt to influence politics through a variety of channels. Corporations, like unions, may not donate money directly to electoral candidates or to party organizations.¹⁹ They may, however, establish affiliated political action committees (PACs).²⁰ The corporation pays the administrative and fundraising expenses of the PAC, which raises money from employees and shareholders of the corporation and then makes contributions directly to electoral candidates or political parties. Those contributions are subject to relatively low dollar limits.²¹

In *Citizens United*, the Supreme Court held that corporations may make unlimited independent expenditures on political

13. See *infra* Part II.

14. See *infra* Part III.

15. See *infra* Part IV.

16. See *infra* Part V.

17. See *infra* Part VI.

18. See *infra* Part VII.

19. 2 U.S.C. § 441b (2012). *Citizens United* invalidated § 441b as applied to “corporate independent expenditures,” but did not invalidate its prohibition on direct corporate contributions to candidates or parties. 558 U.S. at 365.

20. 2 U.S.C. § 441b(b)(2).

21. *Contribution Limits 2013–14*, FED. ELECTION COMM’N, <http://www.fec.gov/pages/brochures/contriblimits.shtml> (last visited May 20, 2013).

communications, including those intervening directly in elections.²² For example, a corporation may finance, produce, and distribute its own advertisements supporting or attacking particular candidates. In practice, most major corporations have little interest in producing political advertisements, in part because they would then have to disclose their role in paying for and producing those advertisements. More relevant to them was the D.C. Circuit's decision in *SpeechNow.org*, which allowed unlimited contributions to "independent expenditure committees"—organizations that engage in political activity independently of specific candidates or parties.²³ These decisions made possible the formation of "super PACs," which can accept unlimited contributions and engage in any type of political communications, so long as they avoid explicitly coordinating their activities with a candidate or party. These organizations played an important role in the 2012 elections, particularly in the Republican presidential primary, in which each candidate was supported by a technically independent super PAC. In the 2012 election cycle, super PACs spent over \$600 million, led by Restore Our Future (supporting Mitt Romney) at \$142 million, American Crossroads (a conservative group led by strategist Karl Rove) at \$104 million, and Priorities USA Action (supporting Barack Obama) at \$65 million.²⁴

The downside of super PACs, from the standpoint of individuals or corporations that want to engage in politics, is that they must disclose their contributors. This is one potential reason why corporations, in general, did not make large contributions to super PACs. Instead, there are three other major types of political intermediaries that corporations can donate to and that are not required to disclose their contributors, each a tax-exempt nonprofit organization defined in the Internal Revenue Code. The Chamber of Commerce is an example of a 501(c)(6) organization, a category that includes "business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues."²⁵ "Social welfare" organizations are those "operated exclusively for the promotion of social welfare" under

22. 558 U.S. at 365.

23. 599 F.3d 686, 696 (D.C. Cir. 2010).

24. *Super PACs*, [OPENSECRETS.ORG, http://www.opensecrets.org/pacs/superpacs.php?cycle=2012](http://www.opensecrets.org/pacs/superpacs.php?cycle=2012) (last visited May 20, 2013).

25. 26 U.S.C. § 501(c)(6) (2012).

section 501(c)(4).²⁶ Both 501(c)(4) and 501(c)(6) organizations may intervene directly in political campaigns, including supporting or attacking candidates, so long as this intervention does not constitute their primary activity; they may spend unlimited amounts on educational activities (including issue advertisements) related to their core purpose; and they are allowed to engage in unlimited lobbying activities related to that purpose.²⁷ Conceptually, that means that they are able to spend forty-nine percent of their money on advertisements that advocate for or against a particular candidate and the rest on issue advertisements. These organizations may have to disclose their electoral expenditures to the Federal Election Commission, but they do not have to disclose contributions unless they are earmarked for specific activities—so donations to their general funds need never be made public.

Tax-exempt 501(c) organizations have become major players in electoral politics, spending over \$300 million in the 2012 election cycle, led by Crossroads Grassroots Political Strategies (Crossroads GPS, a conservative group led by Karl Rove) at \$71 million, Americans for Prosperity (a conservative group backed by the Koch brothers) at \$36 million, and the U.S. Chamber of Commerce at \$35 million.²⁸ Because they are not required to disclose their donors, these 501(c) groups make it possible for contributors to influence elections in secret. In one case, the head of a 501(c)(4), asking potential donors for money to fund a political advertising campaign, said, “Contributions to the [Republican Jewish Coalition] are not reported. We don’t make our donors’ names available. We can take corporate money, personal money, cash, shekels, whatever you got.”²⁹

Finally, traditional 501(c)(3) charitable organizations—those “organized and operated exclusively for religious, charitable, scientific,

26. 26 U.S.C. § 501(c)(4).

27. JOHN FRANCIS REILLY & BARBARA A. BRAIG ALLEN, INTERNAL REVENUE SERVICE, POLITICAL CAMPAIGN AND LOBBYING ACTIVITIES OF IRC 501(C)(4), (C)(5), AND (C)(6) ORGANIZATIONS, at L-2 - L-3 (2003), available at <http://www.irs.gov/pub/irs-tege/eotopic103.pdf>.

28. 2012 *Outside Spending, by Group*, OPENSECRETS.ORG, <http://www.opensecrets.org/outsidespending/summ.php?cycle=2012&chrt=V&disp=O&type=U> (last visited May 20, 2013).

29. Kim Barker, *How Nonprofits Spend Millions on Elections and Call It Public Welfare*, PROPUBLICA (Aug. 18, 2012), <http://www.propublica.org/article/how-nonprofits-spend-millions-on-elections-and-call-it-public-welfare>.

testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals”³⁰—also engage in politics, albeit under greater restrictions than (c)(4) and (c)(6) organizations. Politically oriented think tanks, for example, are typically section 501(c)(3) organizations, ranging from the conservative Heritage Foundation to the liberal Center for American Progress. These think tanks are also an important part of inside-the-Beltway political networks. The Brookings Institution, for example, has been an important source of government officials in the Obama administration. The Center for American Progress was founded by John Podesta, formerly chief of staff under President Clinton, while Senator Jim DeMint recently resigned to become president of Heritage. Other entities organized under section 501(c)(3) are able to engage in activities that closely resemble lobbying, providing donors with privileged access to elected officials. For example, the Congressional Sportsmen’s Foundation receives funding from the National Rifle Association and the trade organization for the firearms industry and includes executives from major manufacturers of guns and ammunition on its board.³¹ The Foundation, which opposes proposed gun control measures, regularly hosts events bringing together industry representatives and legislators, particularly members of the Congressional Sportsmen’s Caucus.³²

In addition, social welfare organizations and charitable organizations are often paired with overt political committees, including super PACs. American Crossroads is a super PAC; its sister organization, Crossroads GPS, is a section 501(c)(4) social welfare organization. This allows the overall organization to funnel money to one entity or the other depending on various factors, including whether donors are willing to have their contributions disclosed. This structure has been widely adopted by other super PACs. For example, President Obama’s super PAC in the 2012 election, Priorities USA Action, had a sister social welfare organization, Priorities USA.

Social welfare organizations are also often paired with section

30. 26 U.S.C. § 501(c)(3) (2012).

31. Mike McIntire, *Charity Takes Gun Lobby Closer to Its Quarry*, N.Y. TIMES, Mar. 7, 2013, at A1.

32. *Id.*

501(c)(3) charitable organizations. For example, Americans for Prosperity, an advocacy organization that spends heavily on electoral politics, is a section 501(c)(4) social welfare organization. Its sister organization, Americans for Prosperity Foundation, is a section 501(c)(3) charitable organization. This combination of a 501(c)(3) and a 501(c)(4) organization is common to many advocacy groups, including the National Rifle Association, the National Abortion and Reproductive Rights Action League, the American Conservative Union, the American Association of Retired Persons, People for the American Way, the NAACP, and the Sierra Club.³³ Politically oriented think tanks often spawn sister 501(c)(4) organizations, such as Heritage Action for America (Heritage Foundation) and the Center for American Progress Action Fund (Center for American Progress). This structure allows the 501(c)(3) entity to use tax-deductible contributions to fund research and educational initiatives that, while politically oriented, do not violate the Internal Revenue Service's ban on lobbying and electoral activities by charitable organizations. The 501(c)(4) entity then uses nondeductible contributions to engage in lobbying and electoral activities.

In general, we simply do not know to what extent corporations are taking advantage of these various avenues for political activity, because 501(c) organizations are not required to disclose their contributors and, as discussed below, corporations are not required to disclose their contributions. We do have some indications, however. For example, in 2009, America's Health Insurance Plans, a trade group funded by health insurers, donated \$86 million to the Chamber of Commerce, which "paid for advertisements, polling and grass roots events to drum up opposition to the [health care reform] bill," according to a Chamber spokesperson.³⁴ We also know that *Citizens United* and *SpeechNow.org*, coupled with a campaign finance system that allows nominally independent groups to raise and spend unlimited amounts of money, gave corporations new ways to influence politics on an even larger scale.

33. Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 656 (1997).

34. Drew Armstrong, *Insurers Gave U.S. Chamber \$86 Million Used to Oppose Obama's Health Law*, BLOOMBERG, Nov. 17, 2010, <http://www.bloomberg.com/news/2010-11-17/insurers-gave-u-s-chamber-86-million-used-to-oppose-obama-s-health-law.html>.

B. Policy and Legal Issues

The specter of large-scale corporate involvement in electoral politics raises a number of important issues. The most obvious is whether corporate political activity is good for democracy and for society. I do not attempt to answer that question in this paper, which is instead concerned with whether corporate political activity is good for corporations and what their shareholders can do about it.

1. Shareholder Welfare

One possibility is that there is nothing for shareholders to worry about because directors and officers only authorize political activity that is good for their corporations, at least on an expected basis,³⁵ and therefore for shareholders. Indeed, this has been the assumption of much corporate law scholarship over the past few decades. In 1981, Victor Brudney claimed, “Doubtless the holders of the bulk of corporate stock do not disagree with most political positions for which their managements spend corporate funds.”³⁶ A few years later, Roberta Romano claimed, “Casual empiricism supports the contention that corporate PACs and political expenditures are in fact vehicles for profit maximization,” citing the tendency of regulated firms to sponsor PACs and the fact that companies typically intervened in state referenda that would have a direct effect on their profitability.³⁷ More recently, Jill Fisch also argued, “[C]orporate political participation is effective. Corporations are able to exert substantial influence on regulatory policy through their political activities and donations.”³⁸ In addition, Robert Sitkoff has claimed that market forces ensure that corporate insiders do

35. A corporation could spend money in support of a candidate who goes on to lose an election, and therefore receive no direct benefit, but this is analogous to spending money on a speculative research and development project that does not bear fruit. In either case, it is plausible that the money spent was a good investment at the time, given the probability of success and the expected payoff.

36. Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 YALE L.J. 235, 237 (1981).

37. Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 995–96 (1984).

38. Jill E. Fisch, *The “Bad Man” Goes to Washington*, 75 FORDHAM L. REV. 1593, 1607 (2006); see also Jill E. Fisch, *How Do Corporations Play Politics? The FedEx Story*, 58 VAND. L. REV. 1495, 1501 (2005) (“[P]olitical activity is not a dispersion of shareholder funds, but an integral and necessary part of a corporation’s operating strategy.”).

not engage in political activity that is not supported by shareholders.³⁹

Corporations certainly do participate in politics to further their own economic interests, and this is particularly true of firms in regulated industries; consider the donation by America's Health Insurance Plans to the Chamber of Commerce, for example, or the massive and expensive lobbying campaign that financial institutions have engaged in to weaken the Dodd-Frank Act and its accompanying regulations. It does not necessarily follow, however, that all or even most corporate political activity results in higher profits or share prices. As Romano recognized, whether that activity is ultimately worthwhile is empirically testable.⁴⁰ In the intervening years, many studies have found reason to be skeptical.

A 2003 meta-analysis of studies comparing contributions by PACs to subsequent legislators' votes found that "PAC contributions show relatively few effects on voting behavior."⁴¹ Based on their own regression analysis of contributions by corporate and labor PACs, the authors concluded, "[T]he evidence that campaign contributions lead to a substantial influence on votes is rather thin."⁴² Two more recent papers that study a broader range of corporate political activity come to even stronger conclusions. Rajesh K. Aggarwal, Felix Meschke, and Tracy Yue Wang examined soft money donations to political parties⁴³ and donations to 527 committees.⁴⁴ They found that political donations were associated with *lower* stock market returns⁴⁵ and that higher levels of political spending were associated with poor corporate governance

39. Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1115 (2002); see also David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After Citizens United*, 89 N.C. L. REV. 1197, 1228 (2011) (arguing that the lack of competition between states over corporate law regarding political activity "suggests that corporate political speech tends to benefit shareholders, not harm them").

40. Romano, *supra* note 377, at 995.

41. Stephen Ansolabehere et al., *Why Is There So Little Money in U.S. Politics?* 17 J. ECON. PERSP. 105, 114 (2003).

42. *Id.* at 116.

43. "Soft money" was not subject to federal limits and was used by political parties to fund some of their activities. Corporate soft money contributions were banned by the Bipartisan Campaign Finance Reform Act of 2002, Pub. L. No. 107-155, 116 Stat. 81 (codified in scattered sections of 2 U.S.C.).

44. These are political organizations that are technically independent of particular candidates or parties.

45. Rajesh K. Aggarwal et al., *Corporate Political Donations: Investment or Agency?* 14 BUS. & POL., no. 1, 2012 at 1, 14-21.

practices,⁴⁶ implying that corporate insiders who are only weakly controlled by shareholders are more likely to waste money on poor political investments. Studying corporate PAC contributions and lobbying activity, John C. Coates IV found that, outside heavily regulated industries, political activity is associated with lower firm valuations (as measured by Tobin's Q⁴⁷) and is most common in corporations with weak shareholder governance.⁴⁸ In addition, Coates found that corporate political activity is most common in firms whose CEO goes on to assume political office,⁴⁹ further strengthening the suspicion that executives spend their companies' money for reasons other than shareholder value maximization.

These findings give us reason to believe that political activity is not simply a benign but risky type of corporate investment in which some bets pay off, some don't, but on average money is well spent. Instead, they imply that good political investments may be the exception rather than the rule, and shareholders should be particularly worried about the potential for political contributions to drain value out of their corporations. These studies are hampered by the fact that they are, of necessity, based solely on donations that corporations are required to disclose, which may be only a small fraction of total political spending. But if that publicly disclosed spending reveals poor investment choices and agency costs, it seems that undisclosed spending would be even more susceptible to those problems.

2. Possible Responses

Within the field of corporate law, most recent attention to the question of political activity has been devoted to the issue of disclosure. As discussed above, many political organizations do not have to disclose the identity of their contributors. Since there is no general rule that corporations must disclose their political spending, shareholders cannot even begin to determine whether their corporations' political activities are in their interests or not. This problem has provoked several

46. *Id.* at 22–25.

47. Tobin's Q is the ratio of the market value of assets divided by the book value of assets.

48. John C. Coates, IV, *Corporate Politics, Governance, and Value Before and After Citizens United*, 9 J. EMPIRICAL LEGAL STUD. 657, 688 (2012).

49. *Id.*

different responses from shareholders and academics.

Shareholders of many large corporations have attempted to require disclosure of political spending by submitting proposals for inclusion on proxy statements; during the 2012 proxy season, thirty-nine of the companies in the S&P 100 index included such proposals on their proxy statements.⁵⁰ In August 2011, a group of law professors petitioned the Securities and Exchange Commission (SEC) to require disclosure of corporate political spending by all public companies under the SEC's existing power to require corporations to make information available to investors.⁵¹ Investors have also attempted to obtain disclosure on the basis of shareholders' traditional rights to inspect a corporation's books and records. In August 2012, for example, the New York State Common Retirement Fund (NYSCRF) demanded that Qualcomm provide information about its political spending.⁵² When Qualcomm essentially refused to comply with the request, the NYSCRF filed suit in the Delaware Court of Chancery under the books-and-records provision of Delaware General Corporate Law;⁵³ the corporation later agreed to disclose its political donations to shareholders.⁵⁴

Mandatory disclosure of political spending would certainly be a good thing.⁵⁵ At a minimum, it would make it possible for the institutions of shareholder democracy to ensure that such spending is being put to appropriate uses. Indeed, the Supreme Court in *Citizens United* seems to have assumed that such disclosure already existed:

50. Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 939 (2013). Thirty-one of those proposals were submitted by institutional investors. *Id.* at 939 n.48. Not counting companies that had already agreed to disclose their political spending, forty-five percent of companies in the S&P 100 index included such proposals. *Id.* at 939.

51. Letter from Comm. on Disclosure of Corporate Political Spending to Elizabeth M. Murphy, Sec'y, U.S. Sec. and Exch. Comm'n (Aug. 3, 2011), *available at* <http://www.sec.gov/rules/petitions/2011/petn4-637.pdf>.

52. Verified Complaint for Inspection of Books and Records at 21, N.Y. State Common Ret. Fund v. Qualcomm Inc., C.A. No. 8170 (Del. Ch. Jan. 2, 2013), *available at* http://www.blbgilaw.com/cases/Qualcomm_data/qualcomm_complaint.pdf.

53. DEL. CODE ANN. tit. 8, § 220 (West 2013).

54. Dan Strumpf, *Qualcomm Settles Disclosure Suit with New York*, WALL ST. J., Feb. 22, 2013, *available at* <http://online.wsj.com/article/SB10001424127887323549204578320500077425818.html>.

55. Bebchuk & Jackson, *supra* note 50, at 941–45; *see also* Jill E. Fisch, *Frankenstein's Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 WM. & MARY L. REV. 587, 638–40 (1991).

With the advent of the Internet, prompt disclosure of expenditures can provide shareholders and citizens with the information needed to hold corporations and elected officials accountable for their positions and supporters. Shareholders can determine whether their corporation's political speech advances the corporation's interest in making profits, and citizens can see whether elected officials are "in the pocket" of so-called moneyed interests." The First Amendment protects political speech; and disclosure permits citizens and shareholders to react to the speech of corporate entities in a proper way.⁵⁶

But required disclosure is neither a panacea nor the sole possible remedy to the problems presented by corporate political activity. Disclosure-based regimes have had limited or no success in other areas where insiders' interests may diverge from those of shareholders. For example, new rules introduced by the SEC in 1992 requiring greater disclosure of executive compensation had little discernible effect on the overall upward trend of CEO compensation.⁵⁷

Furthermore, although disclosure alone would potentially curb some questionable corporate political activities at the margin, it would not on its own give shareholders the power to do anything substantive about spending that they opposed for either political or shareholder value reasons. They could of course choose to vote for alternative board candidates, if a dissident group were to go to the lengths of opposing the incumbent board. Given that political spending concerns are unlikely to outweigh the more traditional issues of maximizing profits and share prices, however, it seems unlikely that the typical shareholder will withhold her vote from directors because they sign off on wasteful political spending—and even more unlikely that a major institutional investor will undertake the type of activist campaign or proxy fight necessary for those votes to matter. Shareholders also cannot impose their preferred policy for political expenditures on a corporation through the proxy process, since any such proposal would have to be advisory in nature.⁵⁸

56. 558 U.S. 310, 370–71 (2010) (quoting *McConnell v. Fed. Election Comm'n*, 540 U.S. 93, 259 (2003) (Scalia, J., concurring in part and dissenting in part)).

57. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 856–57 (2002).

58. A corporation's operations must be managed by its board of directors, not directly by shareholders. *E.g.*, DEL. CODE ANN. tit. 8, § 141 (West 2013). A corporation may reject a

Given these constraints, there is little that shareholders can do to affirmatively prevent corporate insiders from spending money on political activities that are not in the interests of shareholders. Corporate law leaves them with one other recourse: a derivative suit challenging a specific expenditure or program of activity that is allegedly harmful to the corporation. The premise of a derivative suit is that the corporation has been harmed by someone, but its management will not take action against that person—in a prototypical case, because the wrongdoer herself controls the corporation. In this situation, a shareholder can attempt to file suit on behalf of the corporation, with the goal of securing a recovery for the corporation. The corporation's underlying claim is that its directors or officers, in authorizing the challenged political activity, have violated one or more of their fiduciary duties to shareholders, and therefore should be liable for the harm they have caused to the corporation.

The fiduciary duties of corporate insiders, and the ability of derivative suits to enforce them, have been cited as a possible constraint on corporate political activity. One argument is that the existence of fiduciary duties and derivative suits is sufficient to close the subject: fiduciary duties ensure alignment between corporate policies and shareholders' interests, and if insiders violate those duties, they will be punished by derivative suits.⁵⁹ Another set of commentators recognizes that fiduciary duties should create that alignment, but in practice are difficult to enforce. Brudney doubts that either shareholder voting or derivative suits could significantly affect political activities undertaken by management.⁶⁰ Fisch warns against relying on fiduciary duties: "an ample body of scholarship takes the position that stockholders' tools for disciplining their agents are, in large part, ineffective."⁶¹ More recently, in the wake of *Citizens United*, Elizabeth F.R. Gingerich, William Alan Nelson II, and Jonathan Romiti have separately highlighted shareholder derivative suits as a possible mechanism for reining in corporate political spending.⁶²

shareholder proposal that is "not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." Shareholder Proposals, 17 C.F.R. § 240.14a-8(i)(1) (2013).

59. See, e.g., Yosifon, *supra* note 39, at 1228.

60. Brudney, *supra* note 36, at 257–58.

61. Fisch, *supra* note 55, at 638.

62. Elizabeth F.R. Gingerich, *Shareholder Value Diminution and Tools of Redress*:

Today, derivative suits claiming a breach of fiduciary duty face a difficult uphill battle, primarily because of the importance of the business judgment rule in fending off challenges to insiders' decisions. I argue below, however, that courts should look more closely at corporate political activity, requiring corporations to provide a reasonable justification for political expenditures that are challenged by shareholders. With this heightened scrutiny, derivative suits to enforce fiduciary duties could become an effective tool to align political spending with shareholder interests.

III. CORPORATE FIDUCIARY DUTIES AND THEIR ENFORCEMENT

Corporations certainly have the *power* to engage in political activity through the various means described above.⁶³ The fact that a corporation has the power to do something, however, does not mean that its directors and managers may always do that thing with impunity. For example, corporations have the power to purchase property,⁶⁴ but that does mean that a board of directors can cause a corporation to buy property from one of its members at a grossly inflated price without incurring liability. At a minimum, directors and officers must observe a set of core fiduciary duties including the duty of care, the duty of loyalty, and the obligation of good faith.⁶⁵ In general terms, these

Uncertainty in a Post-Citizen United Era, 12 J. ACCT. FIN. 71, 78–80 (2012); William Alan Nelson II, *Post-Citizens United: Using Shareholder Derivative Claims of Corporate Waste to Challenge Corporate Independent Political Expenditures*, 13 NEV. L.J. 134, 155–67 (2012); Jonathan Romiti, Note, *Playing Politics with Shareholder Value: The Case for Applying Fiduciary Law to Corporate Political Donations Post-Citizens United*, 53 B.C. L. REV. 737, 769–73 (2012). Gingerich seems skeptical of the likelihood of success of a derivative suit, considering the importance of the business judgment rule. Romiti, by contrast, seems somewhat optimistic that a shareholder's waste or duty of loyalty claims would prevail. Nelson lists various arguments that shareholders could make in support of their claims. While I am in broad agreement with Nelson and Romiti, I argue in this paper that success will depend on a more fundamental analysis of the business judgment rule and its applicability to corporate political activity.

63. Unless constrained by some other law, a corporation typically has the power to do anything necessary for the promotion of its business or other purpose. *E.g.*, DEL. CODE ANN. TIT. 8, § 121 (West2013).

64. *E.g.*, DEL. CODE ANN. TIT. 8, § 122(4) (West 2013).

65. The Delaware Supreme Court has explained that the obligation of good faith is technically a subset of the duty of loyalty. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006). It's not clear that this distinction makes a difference, since a failure to act in good faith can result in liability either way. *Id.* (“[A] failure to act in good faith may [result in liability], but indirectly. . . . [T]he fiduciary duty of loyalty . . . encompasses cases where the fiduciary fails to act in good faith.”).

require, respectively, that insiders take reasonable care in their actions, avoid making individual profits at the corporation's expense, and take their duties seriously.

If directors or officers breach these duties, shareholders can sue them seeking damages or other remedies.⁶⁶ Suits to enforce fiduciary duties can take virtually any form, limited only by the plaintiff's imagination. One prominent category is suits alleging that directors harmed the corporation by paying excessive compensation to executives or to themselves.⁶⁷ Another important class of shareholder suits is those claiming that a corporation's directors did not adequately protect shareholders' interests when agreeing to a merger or an acquisition by another company.⁶⁸ In both of these contexts, the underlying concern is that directors may be motivated by concerns other than maximizing shareholder value: in the former, doing a favor to the CEO who nominated them to the board and with whom they work regularly; in the latter, keeping control of the corporation so that they can keep their jobs or avoid embarrassment.

Running a corporation can be complicated, however, and it is widely believed that directors and managers should not have to face constant second-guessing by shareholders and judges, particularly if their decisions turn out badly through no fault of their own. This sentiment underlies the business judgment rule, which is corporate insiders' first and most important line of protection against liability for their actions. This rule states that directors and officers fulfill their duty of care by "mak[ing] a business judgment in good faith," so long as they are not personally interested in the judgment, are well informed in making that judgment, and rationally believe it to be in the best interests of the corporation.⁶⁹ A plaintiff who seeks to hold directors or officers

66. This suit may be either a direct or a derivative suit, depending on the nature of the harm suffered by shareholders. See *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996). A suit challenging political activity authorized by directors or officers would be a derivative suit, since a direct suit would have to allege "an injury which is separate and distinct from that suffered by other shareholders, . . . or a wrong involving a contractual right of a shareholder." *Id.* (alteration in original) (quoting *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985)) (internal quotation marks omitted).

67. *E.g., In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006);

68. See, *e.g.*, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

69. AM. LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 4.01 (1994). The business judgment rule is a product of common law, not of statute, so it has no statutory formulation.

liable for an action that allegedly has harmed the corporation must rebut the presumption created by the business judgment rule by proving that the defendants did not act in good faith, had a conflict of interest, did not properly inform themselves, or could not possibly have believed that the action in question was good for the corporation.

There are several justifications for the business judgment rule. One is the need for directors and officers to take risks, which may ultimately turn out badly for their company. It is conventional wisdom that superior financial returns cannot be earned without taking on risk; that people and institutions invest in stocks because they want to receive higher returns than are available from near-risk-free investments such as Treasury securities; and that some degree of corporate risk-taking is essential to a productive economy and overall prosperity. For these reasons, directors and managers should take risks, such as developing new products and entering new markets, that have a significant chance of losing money. In the words of Bayless Manning,

From a social standpoint, innovation and risk-taking are exactly what boards of directors of most companies . . . should be encouraged to pursue. Precisely because many of the innovative projects proposed by the board will inevitably fail, the business judgment rule is most needed to protect directors from liability.⁷⁰

Without the business judgment rule, corporations would underinvest in risky ventures, and society as a whole would suffer.

A second common argument for the business judgment rule is that courts are poorly placed to evaluate business decisions, for at least two reasons. One is that judicial review of corporate action inevitably occurs after the fact and with the benefit of hindsight. As the Second Circuit stated in *Joy v. North*,

[A]fter-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not

70. Bayless Manning, *The Business Judgment Rule in Overview*, 45 OHIO ST L.J. 615, 622 (1984). Note that Manning was summarizing a particular point of view and not necessarily endorsing it as his own.

easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.⁷¹

The other reason is that judges do not typically have experience making business decisions and would be more likely to make bad decisions than would experienced executives. Therefore, allowing substantive, after-the-fact judicial review of business decisions would require managers to guess at what a judge might do in their place, lowering the quality of those decisions. As Judge Richard Posner of the Seventh Circuit put it, "Not only do businessmen know more about business than judges do, but competition in the product and labor markets and in the market for corporate control provides sufficient punishment for businessmen who commit more than their share of business mistakes."⁷² Posner's conclusion is that the free market provides better oversight of directors and officers than the courts could provide.

A third frequent justification is that, without the business judgment rule, people would be reluctant to serve as directors of public corporations. On this view, as summarized by Manning,

[T]he key problem at hand is how to attract, hold, and motivate directors of outstanding capacity to devote their time and attention to the interests of the corporation. . . . [I]f a director is personally honest, has no interest conflict, and (within the restricted limits of the time and attention which can be allocated to the corporation) has paid attention to corporate activities, then the director should be able to sleep at night without worrying about being pilloried by a plaintiff's lawyer or being subjected to the risk of personal liability after

71. 692 F.2d 880, 886 (2d Cir. 1982).

72. *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986), *rev'd* 481 U.S. 69 (1987).

being second-guessed on a business matter years after the fact⁷³

The business judgment rule, therefore, is necessary to ensure that qualified people will be willing to assume director positions, which is ultimately good both for shareholders and for society at large.

If the business judgment rule applies to a particular decision, courts will be highly deferential to the corporate directors or officers who made that decision. There are a few principal avenues that plaintiffs can pursue in seeking to overcome the business judgment rule. One is to allege that insiders were conflicted because they had a personal stake in the decision.⁷⁴ In that case the business judgment rule does not apply, and the court will subject the decision to a higher degree of scrutiny.⁷⁵ Another is to claim that the insiders did not sufficiently inform themselves when making the decision.⁷⁶ If they did not make a considered business judgment, then they should not enjoy the protection of the business judgment rule, and could be held liable for harm that they cause to the corporation as a result. Finally, even if insiders are not conflicted and have sufficiently informed themselves before making a decision, a plaintiff can attempt to claim “waste” of corporate assets. The standard for demonstrating waste is extremely high, however: a challenged transaction must be “so one sided that no business person of ordinary, sound judgment could conclude that the corporation has

73. Manning, *supra* note 70, at 627.

74. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (“[The business judgment rule’s] protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.”).

75. The degree of scrutiny can depend on the nature of the conflict. The simplest case is that a transaction between a corporation and one or more of its directors or officers must meet the standard of “entire fairness”—that is, it must be substantively fair to the corporation—unless it is ratified either by the directors who do not have an interest in the transaction or by the shareholders. *E.g.*, DEL. CODE ANN. tit. 8, § 144 (West 2013). Board ratification may be by a majority of either the disinterested board members or the disinterested members of the committee authorizing the transaction. *Id.* § 144(a).

76. Smith v. Van Gorkum, 488 A.2d 858, 872 (Del. 1985) (“Under the business judgment rule there is no protection for directors who have made ‘an unintelligent or unadvised judgment.’” (quoting Mitchell v. Highland-Western Glass, 167 A. 831, 833 (1933))); *see also* MODEL BUS. CORP. ACT § 8.31(a)(2)(ii) (2010) (eliminating liability unless, *inter alia*, a director “was not informed to an extent the director reasonably believed appropriate in the circumstances”).

received adequate consideration.”⁷⁷ In summary, corporate law has evolved significant barriers that stand in the way of a plaintiff seeking to challenge a business decision made by a corporation’s directors or officers.

IV. CORPORATE LAW AND CORPORATE POLITICAL ACTIVITY

One obvious issue in election law, as applied to corporations, is that corporations are associations of stakeholders (shareholders, managers, employees, etc.) who usually have differing political preferences and opinions. According to the Supreme Court, this is simply a matter of corporate law, to be resolved using the usual tools and principles of corporate law. In *First National Bank of Boston v. Bellotti*, a fundamental case affirming the right of corporations to engage in politics, the Court held:

Ultimately shareholders may decide, through the procedures of corporate democracy, whether their corporation should engage in debate on public issues. Acting through their power to elect the board of directors or to insist upon protective provisions in the corporation’s charter, shareholders normally are presumed competent to protect their own interests. In addition to intracorporate remedies, minority shareholders generally have access to the judicial remedy of a derivative suit to challenge corporate disbursements alleged to have been made for improper corporate purposes or merely to further the personal interests of management.⁷⁸

The central question, then, is what constraints the fiduciary duties of directors and officers, as enforced through shareholder derivative suits, place on corporate political activity.

The decision to spend money on political communications or to contribute money to an organization such as a super PAC or the Chamber of Commerce, whether approved by the board of directors or

77. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006) (internal quotation marks omitted) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)). Technically speaking, a successful waste claim does not render the business judgment rule inapplicable; the business judgment rule applies, but the insiders are held liable anyway because their decision was so egregious. *Id.* (“This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board’s decision will be upheld unless it cannot be ‘attributed to any rational business purpose.’” (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971))).

78. 435 U.S. 765, 794–95 (1978).

delegated by the board to managers, may seem like an ordinary business decision that is protected by the business judgment rule. After all, in concept the corporation is spending money for which it expects to receive some benefit in the form of favorable public policies or favorable treatment by elected officials.

However, shareholders may be able to rebut the business judgment rule presumption on the grounds that the directors or officers authorizing a contribution failed to properly inform themselves regarding its merits; if this claim is successful, the insiders could then be held liable for losses suffered by the corporation. Alternatively, shareholders can argue that the directors or officers were affected by a conflict of interest; because political activity presents a significant risk of conflict, courts should apply a higher degree of scrutiny to political expenditures. If either approach is successful, the result will be that insiders will have to show a reasonable basis for believing that such expenditures will provide a net benefit to the corporation.⁷⁹

A. *Failure To Make an Informed Decision*

In many situations, a plaintiff shareholder could argue that corporate insiders do not merit the protection of the business judgment rule because they failed to make an informed decision regarding a political expenditure. An informed board decision requires that “the directors have informed themselves ‘prior to making a business decision, of all material information reasonably available to them.’”⁸⁰

79. If the plaintiff cannot avoid the business judgment rule, she would have to claim waste, which requires that she show that no reasonable person would have made the contribution in question. While there are hypothetical fact patterns that would warrant a finding of waste (e.g., a regulated utility in California bankrolls a super PAC whose sole purpose is to elect a candidate for dogcatcher in a small town in Maine), the vast majority of corporate political contributions will not fall into this category. Nelson argues that political donations to losing causes constitute waste, since the corporation receives nothing for its expenditure. Nelson, *supra* note 62, at 159. By the same token, however, an investment in a research and development project that fails to produce a commercially viable project would constitute waste; the appropriate moment at which to consider whether an investment might have been considered reasonable is the time when the investment is made, not after its returns are known.

80. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); *see also* MODEL BUS. CORP. ACT § 8.30(b) (“The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.”).

In *Smith v. Van Gorkom*, the Delaware Supreme Court held that a corporation's directors were liable for failing to properly inform themselves about whether an acquisition offer was at a sufficiently high price.⁸¹ In a corporate political activity case, the analogous claim would be that the directors failed to inform themselves about whether a proposed contribution would provide sufficient benefits to the corporation.⁸² The basic principle is that a court should trust a (non-conflicted) board's decision regarding whether a political donation will provide net benefits to the corporation—but only if the directors actually gather the information necessary to make that decision. The plaintiff shareholder could argue that, before signing off on a political investment, the board should demand information similar to that required before authorizing a capital investment: at a minimum, there should be some basis on which to calculate expected returns from the investment, as well as some analysis of alternative political investments.

Defendants are likely to argue that they had all the information they needed. For example, a contribution to the Chamber of Commerce might be defended on the grounds that the Chamber is the largest lobbying and advocacy group for American businesses; News Corp.'s contribution to the Republican Governors Association might be defended on the grounds that it is conventional wisdom that Republicans are better for corporations than Democrats. Neither of these justifications would pass muster, however, if a board were considering a takeover bid or a capital investment. In those cases, a board that didn't consider some form of quantitative analysis would almost certainly be held liable for making an uninformed decision.⁸³

81. 488 A.2d at 874.

82. The discussion here focuses on the substantive issue of what degree of investigation is required to fulfill the duty of care. There is a separate procedural issue that will come into play in an actual derivative suit: in order to overcome the requirement of pre-suit demand on the board, the plaintiff is required to "allege with particularity" that, in this example, the challenged donation was "not the product of a valid exercise of business judgment." *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996). In practice, it could be difficult to allege with particularity that the board did not properly inform itself prior to making a donation, since this would require a specific allegation regarding the non-existence of an investigation. The procedural barriers to derivative suits are a topic outside the scope of this paper. For now, I simply note that if insiders can violate their fiduciary duty of care, but can still win motions to dismiss because plaintiffs cannot find evidence of those violations, that is another argument for changing the procedural rules governing derivative suits.

83. In *Smith v. Van Gorkom*, the board approved an offer at \$55 per share while their company's stock was trading at \$38 per share, a forty-five percent premium, yet was held

Since cash is cash, whether it is being spent on a new factory or donated to a social welfare organization, courts should require that insiders have some quantitative basis for believing that a political expenditure is likely to provide a net benefit to the corporation.⁸⁴

Without that basis, a decision to donate money to a particular political organization is not sufficiently informed, which constitutes a violation of the duty of care.⁸⁵ This breach “rebutts the presumption that the directors have acted in the best interests of the shareholders, and requires the directors to prove that the transaction was entirely fair.”⁸⁶ This should be a difficult task for the defendant insiders, especially for contributions to organizations that pursue a broad political agenda.⁸⁷ It may be reasonable to believe, for example, that a donation to the Chamber of Commerce will reduce the likelihood of more onerous financial regulation, which will reduce compliance costs and protect profit margins for financial institutions. But is this particular political investment worth the cost?

First, there is the basic question of whether the organization in question is one that uses resources efficiently. In ordinary business operations, even if a general course of action is in the best interests of the corporation (say, buying a small competitor), a responsible executive would still ask whether the specific action taken (say, the particular competitor being bought) is a good use of money. Second, as a theoretical matter, voluntary contributions raise free-rider concerns. If one large bank donates money to the Chamber for use in an advertising campaign, even if that campaign produces positive returns, those returns will be shared by all of the bank’s competitors; it is no longer clear that the donation would provide a net benefit to the donating corporation.

liable for not adequately assessing the adequacy of the acquisition price. 488 A.2d at 875.

84. In an analogous context, there is also considerable evidence that acquisitions of other companies are not, in aggregate, a good use of corporate funds. A particular acquisition—even one that turns out badly in retrospect—will not create insider liability if the directors informed themselves sufficiently and considered the decision carefully; but buying another company on a whim, simply on the belief that acquisitions in general are good, could create such liability.

85. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993).

86. *Id.*

87. It is easier to prove the fairness of a contribution to an organization that focuses on a specific issue in which the corporation clearly has an interest. *See Marsili v. Pacific Gas & Elec. Co.*, 124 Cal. Rptr. 313 (Cal. Ct. App. 1975) (upholding a contribution to an association campaigning against a ballot referendum that would have increased the corporation’s taxes and interfered with its building plans).

Third, as discussed above, there is considerable empirical evidence that political expenditures are not a good use of corporate funds in general—making it less likely that any particular donation is a good idea. For these reasons, it should be difficult for defendant insiders to prove the fairness of a political contribution that is not earmarked for a particular issue of interest to the contribution.

In the end, a court could find directors liable for authorizing a political expenditure without a sufficient basis for believing it to be in the best interests of the corporation.⁸⁸ One complication is that many political donations are unlikely to be board-level issues, simply because the dollar amounts involved are too small, and therefore directors would not have an obligation to inform themselves regarding specific expenditures. Still, officers have fiduciary duties too, and “the fiduciary duties of officers are the same as those of directors,”⁸⁹ so corporate political activities authorized by corporate executives also must be made on a sufficiently informed basis.⁹⁰

What would be the result of a decision assigning liability to corporate insiders for a political contribution? Some corporations might simply stop making political donations, except for those dedicated to specific issues that clearly affect the company’s bottom line. Others will continue making contributions to the general funds of multiple-issue organizations like the Chamber of Commerce, but they will sensibly want to avoid the burden of having to prove in court that those contributions were fair to the corporation at the time they were made. In order to recover the protection of the business judgment rule, their directors and officers will make sure they are properly informing themselves. Most likely they will establish internal processes to determine whether specific contributions are good uses of corporate

88. On the other hand, courts may resolve these uncertainties in favor of defendants. Arguably, since a corporation would have received nothing concrete in exchange for a proper political donation (one made on the basis of sufficient information), the fact that it received nothing concrete in exchange for an improper donation cannot be said to be unfair.

89. *Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009).

90. Alternatively, a plaintiff might allege a breach of directors’ oversight duties. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). This would be a very long shot, however, since those oversight duties only extend to assuring the existence of information and reporting systems necessary “to reach informed judgments concerning both the corporation’s compliance with law and its business performance,” *id.* at 970, and liability will only arise if directors “utterly fail[] to implement any reporting or information system or controls; or . . . consciously fail[] to monitor or oversee its operations,” *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

funds according to objective criteria, such as estimates of the benefits that would flow from given policy changes and estimates of the likelihood that those contributions could secure those changes. These processes and the evidence they generate would show that the corporation's directors and officers reasonably believed, on an informed basis, that their contributions were beneficial to the corporation.

Once these processes are in place, the corporation's political expenditures will be protected by the business judgment rule and will not have to meet the test of entire fairness, meaning that directors and officers will be generally immune from liability. The net effect, however, would be to tie corporate political activity more closely to the interests of shareholders, since contributions would not be made without some evidence that they actually provide economic benefits for the corporation.

B. *Conflict of Interest*

1. The Potential for Conflict

Contributions to political organizations create a significant potential for conflicts of interest. In order to benefit from the business judgment rule, the Delaware Supreme Court stated in *Aronson v. Lewis*, "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."⁹¹ As many commentators have noted, executives or directors may use corporate political contributions to further their personal interests or preferences rather than the needs of the corporation and its shareholders⁹²—precisely the problem noted in

91. 473 A.2d 805, 812 (Del. 1984).

92. See, e.g., Bebhuk & Jackson, *supra* note 50, at 942 ("[C]orporate political spending may reflect not only directors' and executives' business judgment, but also their political preferences."); Coates, *supra* note 48, at 664 ("A number of studies present evidence that CPA represents a form of managerial 'consumption' good—consistent with the possibility that it is pursued at the expense of shareholders."); Brudney, *supra* note 36, at 258 ("[M]anagement is substantially free to use corporate assets to urge any political or social views it sees fit."); Ansolabehere et al., *supra* note 41, at 127 ("Organizations' executives and managers may value being part of the Washington establishment."); Romiti, *supra* note 62, at 771–72 ("[W]hen officers or directors exploit their positions of power to further their own political or personal interests, this should be a plain violation of their

the empirical studies discussed above. A CEO may choose to donate to an organization because it will advocate for policies that benefit her as an individual, or because doing so will enhance her own political career.⁹³ In fact, this is precisely what many investors believe is going on: in a 2006 survey, seventy-three percent of shareholders agreed with the statement that “Corporate political spending is often undertaken to advance the private political interests of corporate executives rather than the interest of the company and its shareholders.”⁹⁴ Of course, multiple motivations may be at work in a given contribution. For example, conservative organizations such as Americans for Prosperity and American Crossroads tend to support deregulatory policies that should benefit at least some corporations; at the same time, they support lower individual income taxes on high-income households, which should benefit many corporate directors and executives.

To put this in perspective, in the 2012 elections, Republican nominee Mitt Romney and many Republican candidates campaigned on a platform of making all of the 2001 and 2003 tax cuts permanent and repealing the Patient Protection and Affordable Care Act of 2010,⁹⁵ which increased Medicare taxes on high-income households. The U.S. Chamber of Commerce supported both positions.⁹⁶ Compared with President Obama’s proposal to let the tax cuts expire for the rich (and not repeal the Affordable Care Act), the Republicans’ tax policies were worth about \$600,000 per year for a CEO with an annual income of \$9.6 million—the median total compensation in 2011 of CEOs of companies in the S&P 500 index.⁹⁷ Since most directors of large public

fiduciary obligations to a corporation’s shareholders.”).

93. For example, CEOs of firms that engaged in lobbying were significantly more likely to pursue later political careers than CEOs of other firms. Coates, *supra* note 48, at 679.

94. CTR. FOR POLITICAL ACCOUNTABILITY, CORPORATE POLITICAL SPENDING: A SURVEY OF AMERICAN SHAREHOLDERS 9 (2006), available at <http://www.politicalaccountability.net/index.php?ht=a/GetDocumentAction/i/918>.

95. Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of 26 and 42 U.S.C.). For procedural reasons, the health care reform legislation of 2010 also included the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

96. *Key Vote Alert on S. 3412, the “Middle Class Tax Cut Act,”* U.S. CHAMBER OF COMMERCE (July 25, 2012), <http://www.uschamber.com/issues/letters/2012/key-vote-alert-s-3412-middle-class-tax-cut-act>; *Key Vote Letter on H.R. 6079, the “Repeal of Obamacare Act,”* U.S. CHAMBER OF COMMERCE (July 10, 2012), <http://www.uschamber.com/issues/letters/key-vote-letter-hr-6079-repeal-obamacare-act>.

97. Bernard Condon, *Typical CEO Made \$9.6M Last Year, AP Study Finds*,

companies are well off (and many are CEOs of public companies themselves), lower individual income taxes on the wealthy are in their financial interests as well. Corporate donations that increase the chances of securing low individual income tax rates, therefore, provide a “personal financial benefit” to many of the people responsible for those donations.

Potential conflicts of interest are not limited to the case of rich corporate insiders seeking to lower their own taxes. One reason the NYSCRF chose to sue Qualcomm for access to its books and records seems to be that Irwin Jacobs, the company’s co-founder, the former chair of its board, and the father of its current CEO and board chair, is himself a major Democratic Party supporter who contributed over \$2 million to Democratic-leaning super PACs in the 2012 election cycle.⁹⁸ The suspicion is that, if a corporate insider is willing to give large amounts of her personal fortune to support certain political causes, she might be even more willing to cause the corporation to support those same causes—since she can get the same political benefits at lower cost to herself. A corporate executive might also make political contributions in order to bolster her own personal network, or simply to do favors for people in that network. In 2010, the media conglomerate News Corp. gave \$1 million to the Republican Governors Association—according to New Corp. CEO Rupert Murdoch, because of his personal friendship with Ohio gubernatorial candidate John Kasich.⁹⁹

2. Judicial Evaluation

In order to rebut the business judgment rule presumption, a plaintiff shareholder needs to show that one or more insiders who decided on a political contribution stood to gain some personal benefit

ASSOCIATED PRESS, May 25, 2012, *available at* <http://finance.yahoo.com/news/typical-ceo-made-9-6m-100244495.html>. Together, the differences between Republican and Democratic tax policies amounted to about 9.8 percentage points of tax on investment income and 5.5 percentage points of tax on ordinary income. According to the AP study cited above, the median S&P 500 CEO made \$1.7 million in stock options and \$7.9 million in other compensation, including stock awards.

98. Nicholas Confessore, *State Comptroller Sues Qualcomm for Data About Its Political Contributions*, N.Y. TIMES, Jan. 3, 2013, at A18.

99. Keach Hagey, *Kasich Inspired News Corp.’s RGA Gift*, POLITICO (Oct. 6, 2010), http://www.politico.com/blogs/onmedia/1010/Kasich_inspired_News_Corps_RGA_gift.html.

from that contribution. Showing some degree of interest should be possible in many cases. For example, the same U.S. Chamber of Commerce that ran ads attacking the proposed CFPA also stated, as a policy priority for 2012, “Preserve current marginal individual tax rates and reduced tax rates on capital gains and dividend income.”¹⁰⁰ So a financial institution’s contribution to the Chamber, while arguably advancing the corporation’s interest in limiting regulation of its activities, also advanced its directors’ and executives’ interest in lower personal taxes.

The more complicated question is what to do about this conflict of interest. On the one hand, the existence of a conflict should render the business judgment rule inapplicable. On the other hand, this type of conflict—where an insider receives an ancillary benefit from a transaction, but is not actually on both sides of the negotiating table, and the ancillary benefit seems to come at no cost to the corporation¹⁰¹—probably does not constitute a fully-fledged breach of the duty of loyalty under existing case law. In the language of *Aronson*, the insider derives a “personal financial benefit,” but making the case that there is “self-dealing” is more difficult. The insider could also argue that any “benefit” she receives—lower income tax rates, for example, or any other public policy that she prefers—is enjoyed by all shareholders in the sense that the law applies to all people equally (even though different people are affected differently by specific provisions of the law). The usual approach taken by the courts where there is a conflict of interest—holding a transaction to the standard of entire fairness¹⁰²—has typically been applied in cases where the insider was virtually on both sides of the negotiating table or in takeover cases, not in cases of an ancillary personal benefit that is difficult to quantify.

100. *Capital Markets, Corporate Governance, and Securities Regulation*, U.S. CHAMBER OF COMMERCE, <http://www.uschamber.com/sites/default/files/media/2012PolicyPriorities.pdf> (last visited Nov. 7, 2013).

101. Arguably there is a cost to the corporation, since some proportion of the funds donated to the Chamber (in this example) are going to advocate for lower individual income taxes, not for policies that will directly benefit the corporation. But this is more subtle than the typical duty of loyalty case.

102. *Boyer v. Wilmington Materials, Inc.*, 754 A.2d 881, 898 (1999) (“It is a well-settled principle of Delaware law that where directors stand on both sides of a transaction, they have ‘the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.’” (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983))).

For these reasons, it is currently unclear how a court should evaluate a political contribution that arguably provides some benefit to the corporation but also provides individual benefits to insiders. If there is direct evidence that a political contribution was specifically motivated by a director's or an officer's self-interest, a court should subject the contribution to the entire fairness standard. More often, however, if there is some area in which the recipient organization's efforts intersect with the corporation's interests, the court may be tempted to ignore the fact that insiders benefit personally from other policies supported by that organization.

3. Heightened Scrutiny

From a legal standpoint, this is an uncomfortable situation. We know there is a good chance that corporate insiders may be using their position to direct funds toward organizations that further their interests as individuals, and empirical evidence suggests that this is probably happening, yet existing corporate law does not clearly indicate how this conflict of interest should be addressed. In this subsection, I argue that, because of the widespread potential for and likelihood of conflict, courts should adopt a regime of heightened scrutiny for political activities by corporations.

The first question is whether the business judgment rule should apply in its ordinary form—no liability absent a failure to inform, a clear financial conflict, or waste—should apply to political donations in the first place. The business judgment rule exists for valid policy reasons discussed above: to free corporate leaders to take risks, to constrain judicial second-guessing, and to attract people to serve as corporate directors. However, these concerns apply only tangentially, if at all, to the issue of corporate contributions to political organizations.

First, it seems unlikely that allowing closer scrutiny of such contributions would cause overall corporate risk-taking to fall below its socially optimal level. Money spent to influence elections and policy outcomes is not money spent on developing new technologies or expanding manufacturing capacity. Given that the total supply of electoral winners and of policy decisions is independent of the amount of money expended on them, we cannot say that our society as a whole underinvests in politics. To the extent that politics is a zero-sum game,

underinvestment by corporations does not harm society as a whole. To the extent that higher investment could produce better policies (for example, by bringing more information into the political process), we might worry if corporations were underrepresented relative to other interest groups. If this were true, however, corporations could still spend their own money on lobbying and public relations efforts intended to influence elected officials directly or to encourage shareholders to support their preferred positions. We should also remember that corporations do not themselves have political preferences; any political opinion that a corporation might express must also be held by some individuals, who could use their own resources to bring that opinion into the marketplace of ideas.¹⁰³

The second justification is concerned with business decisions that have concrete, visible outcomes: products that never reach the market, merger synergies that never materialize, capital investments that cost far more than predicted, and so on. The fear is that judges will be influenced by these negative outcomes to believe that the underlying decisions were unreasonable at the time they were made. Again, this fear seems inappropriate to political donations. The potential negative outcome is that the corporation contributes money to an organization that conducts a political campaign that fails. For example, despite the efforts of the U.S. Chamber of Commerce, Congress did create the CFPB in the Dodd-Frank Act. In this case, unlike for an acquisition that goes awry, it is extremely difficult to draw a causal connection between the corporation's decision to contribute money and the eventual outcome. It would make little sense for a plaintiff to argue that a contribution to a losing campaign was a bad decision, since the same could be said of a contribution to a winning campaign: in most cases, given the number of contributors and the number of political actors involved, the outcome cannot be said to turn on any corporation's individual action. The corporation's obvious lack of control over the outcome is what makes it difficult to use a negative outcome as evidence of a poor decision in the first place.

Finally, if political contributions were not protected by the business judgment rule, the most likely result would not be to deter people from serving as corporate directors. Instead, it is far more likely

103. I defer First Amendment considerations until Part VI. *Infra* Part VI.

that many boards would reduce the amount of such contributions, and the remainder would pay much more attention to the subject. The business judgment rule would still apply to the large majority of issues faced by boards of directors. The fact that the rule does not apply in its simple form in other specific contexts, such as insider compensation and takeover defenses, has not made it impossible for corporations to fill their boards. Instead, it has caused directors to pay more attention to insider compensation and takeover defenses, which is a good thing. Carving out political spending from the scope of the rule would have a similar, limited impact on boards.

For these reasons, there is no social imperative dictating that the simple business judgment rule should apply to all corporate political activity. The widespread possibility that insiders are using political donations to further their personal interests, in ways that are not easily constrained by the duty of loyalty, implies that we should consider alternatives to the rule. But if we dispense with the business judgment rule for political contributions, what should replace it? Subjecting every single donation to the entire fairness standard would probably go too far, essentially eliminating corporate political activity (and raising First Amendment concerns).

The law of mergers and acquisitions provides a useful example of a possible alternative. Like political expenditures, sales of corporations present a significant risk of a conflict of interest that may be difficult to prove in a particular case. The risk is that directors (including, but not limited to, executives) may attempt to fight off a takeover in order to preserve their current positions, or favor one transaction over another because of its impact on their personal financial or career interests. For these reasons, Delaware courts do not apply the business judgment rule in its simple form to corporate changes of control, and have instead created their own legal standards.¹⁰⁴ These standards are applied prior to the business judgment rule, even in the absence of concrete evidence that a board is motivated by entrenchment: "Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business

104. See generally *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

judgment rule may be conferred.”¹⁰⁵ In this context, any defenses must be based on a reasonable belief that the takeover attempt constitutes a threat to the corporation or its shareholders;¹⁰⁶ the defenses must be reasonable in relation to the threat posed;¹⁰⁷ and, once a breakup or change of control becomes inevitable, they may not favor one bidder at the expense of another.¹⁰⁸ Only if these conditions are met does the business judgment rule apply.¹⁰⁹

Similarly, the courts have the opportunity to create a new standard for evaluating challenges to corporate political contributions—another area in which the “omnipresent specter” of conflict warrants particular scrutiny. In similar contexts, they have shown considerable creativity in devising such standards.¹¹⁰ The test for political donations should be similar to that used in change-of-control situations. Courts should require defendant insiders to prove that they had “reasonable grounds for believing” that the contribution in question would provide a net benefit to the corporation, “a burden satisfied by a showing of good faith and reasonable investigation.”¹¹¹ This is an appropriate standard of evaluation because it embodies the requirement that political activities should provide net benefits to the corporation on an expected basis—an application of the general principle that corporate actions should create economic value and benefit shareholders. By focusing on the knowledge and beliefs of insiders at the time of the contribution, the proposed standard acknowledges the fact that many particular donations, considered after the fact, will not turn out to have provided

105. *Unocal*, 493 A.2d at 954.

106. *Id.* at 955.

107. *Id.*

108. *Revlon*, 506 A.2d at 184.

109. *Id.* at 180 (“While the business judgment rule may be applicable to the actions of corporate directors responding to takeover threats, the principles upon which it is founded—care, loyalty and independence—must first be satisfied.”).

110. For another example of how courts have dealt with situations where there is a threat but not the certainty of a conflict of interest, consider the Delaware Supreme Court’s treatment of cases where a board’s special litigation committee recommends dismissal of a shareholder derivative action: first the corporation must prove independence, good faith, and reasonable investigation on the part of the committee; then, even if that hurdle is cleared, the court should use “its own independent business judgment” to decide whether or not to dismiss the suit. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–89 (Del. 1981).

111. This proposal adapts the language used of *Revlon*: “This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation.” 506 A.2d at 180.

net benefits (and, in any case, it is extremely difficult to estimate those net benefits). But by requiring reasonable grounds for that belief based on a reasonable investigation, the standard does not allow insiders to direct corporate funds to their preferred organizations on the basis of hopeful guesses or conclusory assertions regarding corporate benefits.

In practical terms, the effect of this standard on corporate behavior would probably be similar to that produced by court decisions assigning liability to insiders for failure to inform themselves regarding political contributions, discussed above. In court, defendant directors or officers could be required to show that they believed their contributions would be beneficial to the corporation, and that that belief was based on a reasonable investigation. To protect themselves against this possibility, they would either scale back their program of political spending or subject it to considerably more scrutiny, creating internal procedures to ensure that each contribution was supported by a quantitative analysis showing a plausible likelihood of delivering a net benefit to the corporation. This would help align political activities with the interests of shareholders rather than the personal preferences of directors and officers.

Another possibility is that the board could choose to submit political contributions for shareholder approval. In a typical transaction between a corporation and an insider, as long as the details of the transaction are disclosed, along with any potential conflicts of interest, shareholder ratification has the effect of restoring the protection of the business judgment rule.¹¹² Since the underlying reason for heightened scrutiny of political expenditures is the threat of conflict of interest, shareholder ratification should have the same effect here. (The board's duty to properly inform itself before submitting a program of political contributions to shareholders would still apply, since the shareholders must themselves be fully informed.)

In any case, this heightened standard for judicial evaluation of political activities would help ensure that corporations' political spending is more closely focused on initiatives that have a good chance of promoting shareholder value and make it harder for executives to direct contributions based on their personal financial interests or ideological preferences. By requiring corporations to investigate and

112. DEL. CODE ANN. tit. 8, § 144(a)(2) (West 2013); *In re Wheelabrator Tech., Inc. S'holders Litig.*, 663 A.2d 1194, 1203 (Del. Ch. 1995).

substantiate the merits of their political activities, it would also make it possible for shareholders to come to an informed judgment about the relevance and value of those activities. This would help make the Supreme Court's assumption in *Bellotti*—that “shareholders may decide . . . whether their corporation should engage in debate on public issues”¹¹³—a reality.

V. CORPORATE GOVERNANCE OF CONTRIBUTIONS TO CHARITABLE AND SOCIAL WELFARE ORGANIZATIONS

The argument above seeks to ensure that corporate political activity actually serves the best interests of the corporation and its shareholders, rather than the personal interests of well-placed insiders, by applying common principles of corporate law. From a governance perspective, contributions to politically oriented charitable organizations present the same problems as political spending in general: they represent an opportunity for insiders to use the corporation's money to pursue their financial interests, support their ideological preferences, or advance their future political careers. Contributions to politically oriented 501(c)(3) charitable organizations pose a particular problem, however, which may also apply to contributions to 501(c)(4) social welfare organizations. Corporate law currently grants to charitable contributions an additional layer of protection from shareholder challenge, essentially allowing any gift to a qualifying organization that is reasonable in amount.

A. *Corporate Law and Charitable Contributions*

Historically, it was legally unclear whether corporations had the power to make charitable contributions. Modern statutes, however, have uniformly granted this power to corporations.¹¹⁴ These statutes come in two general forms. One provides a general authorization to make contributions for the public good. In Delaware, for example, corporations may “[m]ake donations for the public welfare or for

113. *First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765, 794 (1978).

114. See Stevelman Kahn, *supra* note 33, at 594–609; R. Franklin Balotti & James J. Hanks, Jr., *Giving at the Office: A Reappraisal of Charitable Contributions by Corporations*, 54 BUS. LAW 965, 970–73 (1999).

charitable, scientific or educational purposes.”¹¹⁵ The other specifies that such contributions need not provide any benefit to the corporation. New York, for example, allows corporations to “make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes.”¹¹⁶ The distinction is potentially significant: the New York statute explicitly allows for charitable contributions that do not benefit the corporation, while the Delaware statute only confers a specific power that, one might argue, should only be used to benefit the corporation and its shareholders. After all, the same section of the Delaware Corporate Law also gives corporations the power to buy and sell property,¹¹⁷ but directors and officers must observe their fiduciary duties in authorizing any such transactions.

In practice, judicial interpretation of these statutes, at least in Delaware, has largely written traditional corporate governance concerns out of the law. In *Theodora Holding Corp. v. Henderson*, the Delaware Chancery Court held that “the Delaware statute . . . must . . . be construed to authorize any reasonable corporate gift of a charitable or educational nature.”¹¹⁸ The court further held that a donation was reasonable if it fell within the amount allowed as a tax deduction by the IRS.¹¹⁹ This rule was upheld by the Delaware Supreme Court in *Kahn v. Sullivan*,¹²⁰ in which the Occidental Petroleum Corporation committed almost \$100 million for the construction and operation of a museum to hold the art collection of Armand Hammer, its CEO and chair.¹²¹

Theodora and *Kahn* seem to imply that a corporation may donate up to 10 percent of its taxable income (the current limit for tax-deductible contributions) to any legitimate 501(c)(3) organization, regardless of whether the donation will benefit the corporation in any way. They leave open the question of how much a corporation may

115. DEL. CODE ANN. TIT. 8, § 122(9) (West 2013). In this category I include states where one statutory provision authorizes charitable contributions and another authorizes other contributions in the interests of the corporation. The common factor is that neither set of states specifically authorizes corporate decision-makers to ignore corporate benefit in making such contributions.

116. N.Y. BUS. CORP. LAW § 202(a)(12) (McKinney 2012).

117. DEL. CODE ANN. tit. 8, § 122(4) (West 2013).

118. 257 A.2d 398, 405 (Del. Ch. 1969).

119. *Id.*

120. 594 A.2d 48, 61 (Del. 1991).

121. *Id.* at 54.

donate to 501(c)(4) social welfare organizations, since those donations are not tax-deductible, at least not as charitable contributions.¹²² One literalist interpretation of the case law is that contributions to social welfare organizations should not be treated as charitable donations because they are not tax-deductible under the same provision of the Internal Revenue Code; on this argument, these contributions should instead be treated like other types of political spending. Other interpretations are possible, however. Since 501(c)(4) organizations are officially devoted to promoting social welfare, they seem at first glance to serve a similar societal purpose to traditional 501(c)(3) charities. By that logic, the law should put contributions to both types of organizations on equal footing, and both should be considered reasonable so long as they do not exceed 10 percent of taxable income in aggregate. For the remainder of this Part, I assume that donations to 501(c)(3) and 501(c)(4) organizations are treated the same way.

B. Potential Constraints on Political Contributions to Charitable Organizations

Current law, however, does not give directors and officers unbridled discretion to make charitable contributions. First, insiders may not make such contributions in violation of their fiduciary duties, particularly the duty of loyalty.¹²³ As mentioned previously, the use of corporate funds for political purposes will often implicate the personal interests of directors or managers, whether financial or ideological. If plaintiff shareholders can establish that a conflict of interest exists, the business judgment rule should become inapplicable. This will be difficult in practice, since most courts are likely to hold that a CEO's ideological agreement with the Heritage Foundation or the Center for American Progress does not create a sufficiently worrisome conflict of interest. Even if the plaintiff is successful, it is not clear what would happen next: since an ordinary charitable contribution is made without an expectation of receiving a benefit in return, there is no obvious

122. Under some circumstances they are deductible as business expenses.

123. In *Kahn v. Sullivan*, the lower court rejected the objecting plaintiffs' claim that the business judgment rule should not apply, but only because "the Objectors had not established any facts that the Special Committee had any self-interest in the transaction either from a personal financial interest or from a motive for entrenchment in office." 594 A.2d at 60.

standard against which to measure a conflicted contribution.

More generally, we should ask whether the current permissive treatment of corporate charitable contributions should apply to political spending. In *Theodora*, the case that defined a “reasonable” contribution as one that qualified as a tax deduction under the Internal Revenue Code, the Delaware Chancery Court based its holding on a policy justification that arguably no longer applies today. The court described charitable contributions as a means of protecting corporations in general from public unrest: “[C]ontemporary courts recognize that unless corporations carry an increasing share of the burden of supporting charitable and educational causes that the business advantages now reposed in corporations by law may well prove to be unacceptable to the representatives of an aroused public.”¹²⁴ This was written in 1969, a time when there was considerably more public opposition to the free-market capitalist system than exists today. The court based its holding on *A.P. Smith Manufacturing Co. v. Barlow*,¹²⁵ a leading case on corporate philanthropy. In that case, the *Theodora* court recounted,

[T]he Supreme Court of New Jersey upheld a gift of \$1500 by the plaintiff corporation to Princeton University, being of the opinion that the trend towards the transfer of wealth from private industrial entrepreneurs to corporate institutions, the increase of taxes on individual income, coupled with steadily increasing philanthropic needs, necessitate corporate giving for educational needs even were there no statute permitting such gifts The court also noted that the gift tended to bolster the free enterprise system and the general social climate in which plaintiff was nurtured.¹²⁶

Indeed, *A.P. Smith Manufacturing Co.*, decided in 1953, is thoroughly imbued with the spirit of the Cold War. After recalling the efforts of corporations during two world wars and the Great Depression, the New Jersey Supreme Court continued:

124. *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 404 (Del. Ch. 1969).

125. 98 A.2d 581 (N.J. 1953).

126. 257 A.2d at 404.

[Corporations] now recognize that we are faced with other, though nonetheless vicious, threats from abroad which must be withstood without impairing the vigor of our democratic institutions at home and that otherwise victory will be pyrrhic indeed. More and more they have come to recognize that their salvation rests upon sound economic and social environment [sic] which in turn rests in no insignificant part upon free and vigorous nongovernmental institutions of learning.¹²⁷

In other words, to fight off communism, we need corporations to give money to Princeton University.¹²⁸

Virtually none of these justifications for corporate philanthropy is still relevant. The top tax rate on ordinary income has fallen from ninety-one percent in 1953 and seventy-seven percent in 1969 to 44.6 percent in 2013.¹²⁹ More importantly, corporate dividends are now taxed as long-term capital gains, so the tax rate on dividends has fallen from ninety-one percent to twenty-five percent, eliminating the tax incentive during the post-World War II period for corporations to hold on to their profits. The shareholder value revolution of the past three decades has led corporations to significantly increase the share of profits that they distribute to shareholders, whether as dividends or stock buybacks. A huge increase in income inequality has swelled the ranks of the super-rich, whose charitable contributions dwarf those of any corporation.¹³⁰ In 2011, corporations were responsible for less than five percent of the \$298 billion donated to charitable organizations in

127. 98 A.2d at 586.

128. *A.P. Smith Manufacturing Co.* may itself be the result of collusion between the parties and the court, which wanted to authorize corporate charitable contributions for public policy reasons. Geoffrey Miller, *Narrative and Truth in Judicial Opinions: Corporate Charitable Giving Cases*, 2009 MICH. ST. L. REV. 831, 837–41 (2009). If that is true, the entire line of Delaware cases allowing corporations to donate to charities is founded on a sham to begin with.

129. Citizens for Tax Justice, *Top Federal Income Tax Rates Since 1913*, (Nov. 2011), <http://www.ctj.org/pdf/regcg.pdf>.

130. In 2006, for example, Warren Buffett committed to donate stock worth over \$37 billion at the time. Timothy L. O'Brien & Stephanie Saul, *Buffett to Give Bulk of His Fortune to Gates Charity*, N.Y. TIMES, Jun. 26, 2006, at A1. At least ninety-two super-wealthy families have signed the Giving Pledge, promising to donate at least half of their wealth for charitable purposes. Geoffrey A. Fowler, *More Billionaires Vow to Give Money Away*, WALL ST. J., Sept. 19, 2012, at A7.

the United States.¹³¹ The American charitable sector has little need for corporate philanthropy (particularly educational institutions like Princeton University, which has a \$17 billion endowment¹³²). The idea that corporate giving is necessary to protect the free enterprise system also seems far-fetched. The Cold War is over, American-style capitalism has no serious rival as an economic system, and what diffuse antipathy toward corporations exists has no organized political expression. The “salvation” of the American corporation is not at stake, and corporations play only a bit part in the maintenance of our vital “democratic institutions.”

This implies that we should rethink how corporate law treats charitable contributions. Recall that, in states like Delaware, the letter of the statute simply grants corporations the power to make contributions to charitable organizations, just as it grants them the power to buy and sell property. Basic governance principles dictate that a corporation’s powers should be used for the benefit of the corporation and its shareholders. The vague idea that corporations should contribute to the common good has led courts to suspend that basic rule in the case of charitable donations, arguing from public policy grounds that no longer apply. The result is that the law imposes little restraint on donations made by corporate insiders: “in most states, managers may approve contributions as they choose, for any purpose they choose, to whatever qualifying charity they decide, and without regard to shareholder interests.”¹³³

The simplest solution would be for courts to simply conclude that charitable contributions must be made with the expectation of some net benefit to the corporation, as is the case with ordinary business decisions. A manager would not be allowed to pay \$100 for goods worth \$50, and by the same token the same manager should not be allowed to contribute \$100 if the expected returns to the corporation (marketing, community goodwill, other collateral benefits) are only

131. *Giving Statistics, CHARITY NAVIGATOR*, <http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=42> (last visited May 24, 2013).

132. Martin Mbugua, *Princeton Endowment Earns 3.1 Percent Return, Boosts 10-Year Average*, *PRINCETON UNIVERSITY* (Oct. 19, 2012), <http://www.princeton.edu/main/news/archive/S35/06/60S04/index.xml>.

133. Balotti & Hanks, *supra* note 114, at 982.

\$50.¹³⁴ This might seem like a stark about-face for the courts. But it is important to bear in mind that we are dealing with the interpretation of an ambiguous statute, not the revision of a statute, at least in Delaware and similar states.¹³⁵ While perhaps unlikely, it is not implausible that a court could decide to hold charitable contributions to the same standards as other business decisions.

Alternatively, the courts could require a net corporate benefit for contributions to politically oriented organizations, but continue to treat donations to other charities according to the principles of *Theodora* and *Kahn*. The basis for this distinction is that the public policy concerns that justify traditional corporate philanthropy—in *A. P. Smith Manufacturing Co.*, the court cites gifts to universities, local community chests, the American Red Cross, the Boy Scouts and Girl Scouts, and 4-H Clubs¹³⁶—do not justify corporate intervention in politics. While corporate philanthropy might marginally increase public support for free market capitalism, it is hard to see how corporate involvement in politics could have that effect—especially given people’s largely negative perceptions of corporate political activity. In a 2012 poll, eighty-nine percent of respondents agreed that there is “[t]oo much corporate money in politics.”¹³⁷ This is true even though no one really knows how much corporate money there is in politics; the point is that people are unlikely to think more fondly of corporations because they are contributing to political causes. Donations in general might also promote the common good by helping to meet the “steadily increasing

134. This standard would also mean that corporate managers could no longer force the federal government (and, by extension, taxpayers) to contribute to their preferred charities; under the current system, with a thirty-five percent marginal corporate tax rate, a \$100 donation is in effect split between \$65 from the corporation and \$35 from the government. Instead, charitable contributions would be limited to legitimate business expenses (those that have the expectation of benefitting the company), which would be deductible either way.

135. Furthermore, there is at least some support in the Delaware cases for such an interpretation. In *Theodora*, the court pointed to particular benefits that the corporation and its shareholders could receive as a result of the contested contribution. The Chancery Court opinion on appeal in *Kahn* (Sullivan v. Hammer, CIV. A. No. 10823, 1990 WL 114223 (Del. Ch. Aug. 7, 1990)) can be read to imply that “a benefit to the corporation must accompany a charitable contribution.” Balotti & Hanks, *supra* note 114, at 978. In that matter, both the Chancery Court and the Supreme Court were constrained by the fact that they were reviewing a settlement reached between the litigants.

136. 98 A.2d 581, 585 (N.J. 1953).

137. Brad Bannon, *Support for Reform of Corporate Political Spending Practices*, PUBLIC CITIZEN (Oct. 18, 2012), <http://www.citizen.org/documents/bannon-communications-research-executive-summary.pdf>.

philanthropic needs” referred to by in *Theodora*. But while many people might think there are unmet needs for funding for medical research, or education, or homeless shelters, few people think that what our society needs are more political white papers, lobbying campaigns, or issue ads. Although a functioning democracy requires organized interest groups, those groups by their very nature can appeal to their supporters’ self-interest; they do not depend on the type of philanthropic generosity envisioned by *A.P. Smith Manufacturing Co.* and *Theodora*.

Since contributions to political charities and social welfare organizations do not promote the public policy ends envisioned by the courts, they should not benefit from the special treatment that courts have traditionally applied to charitable contributions. This principle would require courts to draw lines between political and non-political charities, which could be done in various ways. Perhaps the simplest would be to require plaintiff shareholders to establish that a given charity is primarily devoted to influencing public policy rather than, say, research or education. While this might be difficult to prove for many inside-the-Beltway think tanks, it should be straightforward for social welfare organizations that spend virtually all their money on political advertisements.

In either case—whether an expected net benefit is required for all charitable contributions or just for those to politically oriented organizations—a donation to a politically oriented charity would be treated like any other political donation, under the principles discussed in the previous Part. To avoid liability, directors and officers would have to have a reasonable basis for believing that their contributions would have expected benefits exceeding their costs; simply asserting that donating money to Princeton University would help the corporation would not be enough. In summary, the corporate governance of political contributions should not depend on whether the recipient is a 501(c)(3), 501(c)(4), or 501(c)(6) organization, or a super PAC. In all cases, such contributions should only be made if they are reasonably believed, on an informed basis, to be in the best interests of the corporation and its shareholders.

VI. POTENTIAL CONSTITUTIONAL CONCERNS

A decision by courts to apply a higher degree of scrutiny to corporate political activity, as suggested in Part IV.B.3, above, could have the effect of reducing the volume of corporate contributions to political organizations, which could be seen as reducing the volume of political speech by corporations. This raises the question whether a court, by raising the bar for insider defendants seeking to defeat a shareholder challenge, is impermissibly restricting the corporation's right to free speech under the First Amendment.¹³⁸

It seems unlikely that this type of heightened scrutiny would be found unconstitutional, for several reasons. As a starting point, there is no restriction on the corporation's right to engage in political speech. Given that right, and assuming that donations of money are the functional equivalent of speech, the present question is what corporate governance principles determine what the corporation actually "says."¹³⁹ After all, neither an ordinary shareholder, nor an ordinary employee, nor a union representing a majority of a corporation's employees may unilaterally decide what the corporation says. Although corporate law places most operating decisions in the hands of the board and the managers it selects, this is not an absolute principle, much less a constitutional one. There must be some set of legal rules that determine who among a corporation's stakeholders can speak for the corporation; the simple fact that one set of legal rules results in a lesser volume of political donations than another cannot imply that the latter is constitutional while the former is not. Short of a regime that makes it extremely difficult for a corporation to engage in political speech—such as, for example, a requirement that political activities receive unanimous shareholder approval—any set of rules that is reasonably typical of corporate law in general should be constitutionally permissible.

Second, consider the substance of the heightened scrutiny suggested above. In essence, the proposal is to require that decisions

138. A decision by courts to require that directors and officers be sufficiently informed when making political contributions, as suggested in Part IV.A, above, should not present any constitutional concerns. In that case, the courts would simply be applying a rule that governs all corporate activity. See Brudney, *supra* note 36, at 254–55.

139. See Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?* 124 HARV. L. REV. 83, 86 (2010).

regarding political contributions be taken in the good faith belief, on a reasonably informed basis, that those contributions will benefit the corporation. This is the same standard that corporate law already applies to other transactions where there is significant potential for a conflict of interest, not a new hurdle specifically aimed at political speech. Saying that this standard is unconstitutional is the same as saying that the Constitution demands that a particular group of corporate insiders be allowed to unilaterally determine what the corporation says, in defiance of general principles of corporate law.

Third, if such a standard would reduce the volume of corporate political speech, it is a particular kind of speech that would be deterred: political contributions that do *not* serve the overall interests of the corporation and its shareholders. Contributions that do benefit the corporation, for traditional profit-maximization reasons, would remain safe from shareholder attack, since insider defendants would only have to show a reasonable basis for making those contributions. It is hard to see how a corporation's right to free speech could be construed to require that corporate insiders be allowed to make political contributions that are in their own interests but *not* in the interests of the corporation itself.

Finally, the Supreme Court in *Citizens United* itself acknowledged the importance of "corporate democracy" in regulating corporate speech. The Court brushed off the argument that independent political expenditures by corporations would coerce shareholders to fund political speech, citing *Bellotti*: "There is, furthermore, little evidence of abuse that cannot be corrected by shareholders 'through the procedures of corporate democracy.'" ¹⁴⁰ That passage from *Bellotti*, cited in full above, specifically referred to "the judicial remedy of a derivative suit to challenge corporate disbursements alleged to have been made for improper corporate purposes or merely to further the personal interests of management."¹⁴¹ My argument, above, is simply that the courts should evaluate those derivative suits recommended by the Supreme Court using a legal standard, based on ordinary principles of corporate law, that is appropriate to the legal issues that they present. The standard itself—requiring that insiders have an informed basis for

140. *Citizens United v. Fed. Election Comm'n*, 130 S. Ct. 876, 911 (2010) (quoting *First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765, 794 (1978)).

141. 435 U.S. at 794.

believing that a contribution benefits the corporation—substantively reiterates the basic premise of all derivative suits. Corporate democracy, like any democracy, requires a set of rules. For corporate democracy to work, those rules should be chosen to maximize the chances that corporations will generally act in the best interests of their shareholders—not to enshrine the prerogative of directors and officers to speak for the corporation.

VII. WHAT CORPORATE LAW CAN ACCOMPLISH

This paper attempts to contribute to the solution of an important corporate governance problem. *Citizens United* and related decisions have expanded the power of corporations to intervene in the political process, but it is far from clear, as a practical matter, who should have the authority to exercise that power. While corporate law delegates most powers to the discretion of directors and officers, corporate political activity presents the particular risk that those insiders will use their power to further their personal interests rather than those of the corporation and its shareholders.

There are various plausible solutions to this problem and to the related, larger, and more debatable problem of excessive corporate influence in American politics. Since *Citizens United*, several legal, regulatory, and legislative initiatives have attempted to require that corporations disclose their political spending. These include NYSCRF's books-and-records suit against Qualcomm, the request that the SEC require disclosure of political spending, and the DISCLOSE Act, which would have increased mandatory disclosure of election-related spending but failed to clear Congress in 2010. One could envision considerably broader solutions, such as, at one extreme, an electoral system based on mandatory public financing.

This paper has outlined various arguments for bringing corporate political spending under closer judicial scrutiny and thereby giving shareholders more influence over that spending. This issue is important for two reasons. First, even if it is required, disclosure is not a panacea. For example, it is not clear that increased required disclosure of executive compensation will produce any substantive change in actual compensation practices. Even if shareholders can find out how a corporation is spending its money, in many cases they will still need a

way to challenge that spending. Otherwise, executives of an otherwise successful and profitable company will often be able to continue business as usual when it comes to politics.

Second, the solutions proposed by this paper could be implemented by the courts now, without requiring an act of Congress (or the Delaware General Assembly) or a ruling by the SEC. The path of least resistance is for the courts to approve political contributions as valid exercises of business judgment (and to rubber-stamp all charitable contributions that qualify for a tax deduction), but this deference is not the necessary result of fundamental constitutional or even statutory principles. Both the business judgment rule and the “reasonableness” test for charitable contributions are the product of policy judgments by previous courts: attempts to balance the principle of shareholder primacy with the need for corporate risk-taking, in one case, and with the perceived need to further the public good, in the other. To the extent that judges today believe that the lack of shareholder oversight of corporate political spending represents an important problem, corporate law already provides the tools necessary to do something about it. Furthermore, there is a clear precedent in the Delaware courts for increasing scrutiny of insider behavior as new opportunities for conflict appear: this is exactly what they did beginning in the 1980s in response to a wave of hostile takeovers and the invention of a new array of creative takeover defenses.

How our political, regulatory, and legal systems will eventually adapt to the increase in corporations’ potential political influence is unclear today. This paper argues for a legal regime in which corporate political spending must be aligned with the interests of shareholders, shareholders can sue to challenge particular political contributions, and corporate insiders must defend the substance of their spending decisions in court. Compared to the current situation, that would be an important step forward.

