

**PREPARED WRITTEN TESTIMONY**  
**OF**  
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**PROFESSOR OF LAW**  
**BEFORE THE**  
**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT**  
**SPONSORED ENTERPRISES**  
**MARCH 11, 2010**

Thank you Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee for inviting me to testify before you on corporate governance after the *Citizens United* case. I am testifying today in my own capacity and not as a representative of Stanford University or any other organization.<sup>1</sup>

As a preface to my remarks, I would like to point out that my field of expertise is corporate governance and not constitutional law. I will therefore limit my remarks to the implications of, and potential responses to, the *Citizens United* case from a corporate governance perspective. I also would like to note that while I will discuss potential responses to *Citizens United* that Congress may consider, corporate law is generally the province of state law. My intent is not to express a preference for federal legislation over state legislation, but rather to discuss the content of an appropriate legislative response.

In *Citizens United*, the Supreme Court held that the First Amendment protects the use of corporate funds to advocate the election or defeat of a candidate for public office. This protection now extends to public corporations, which are the subject of this testimony.<sup>2</sup> A public corporation's political advocacy will consist of the following: The expression of views formed by management and funded by shareholders, subject to oversight by the corporation's board of directors. Management's control over corporate funds used for political activities of course parallels management's control over funds used to build plants, to acquire equipment, to hire employees and to run the business in general.

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<sup>1</sup> Some of the views I express in this testimony are contained in a article scheduled to appear in the March 2010 issue of Forbes Magazine, which I have written with my Stanford Law School colleague, Ronald Gilson. I have attached that article as an annex to this testimony.

<sup>2</sup> Political speech by public corporations raises governance issues that differ from those raised with respect to political speech by private corporations and nonprofit corporations. In this testimony, I express no views regarding whether the governance structures of those types of entities should be modified in light of *Citizens United*.

There is a governance structure in place in public companies that is designed to induce management to operate the corporation in a way that advances the interests of shareholders, a goal generally understood as maximizing share value over time within the limits of the law. After *Citizens United*, the issue arises whether the current governance system can accommodate management's use of corporate funds for political advocacy. The Supreme Court recognized this issue when it rejected the Government's constitutional argument that corporate speech should be restricted in order to protect dissenting shareholders. The Court suggested that this concern "[can] be corrected by shareholders 'through the procedures of corporate democracy.'" *Citizens United v. FEC*, slip op. p. 46 (quoting *First National Bank of Boston v. Bellotti*, 435 U.S. 765, 794 (1978)). With respect to public corporations, the Court stated that "the remedy is not to restrict speech but to consider and explore other regulatory mechanisms." *Id.* Thus, the Court recognized that *Citizens United* would allow corporate speech but the case left open the question of whose speech. That will be determined by the governance structure through which corporations speak.

I offer at the least the beginning of the Court's suggested exploration here. The threshold question is: What can shareholders do under the governance regime if they would like to influence management's use of corporate funds for political activities? The answer is "not much." Management will control corporate speech just as it controls other expenditures.

The only tool available to shareholders to influence management's political expenditures is their right to vote annually for nominees to the company's board of directors. That mechanism, however, is poorly designed for this purpose. It does not allow shareholders to exert any sort of advance approval power. Nor does it realistically allow shareholders to vote out of office directors whom they believe, after the fact, have allowed management to misallocate corporate funds for political activities.

In the typical board election, a slate of directors is nominated by the board itself, and shareholders are given the opportunity either to vote in favor of the nominees or to withhold their votes from one or more nominees. There is rarely a competing slate of nominees, as there typically is in an election for public office. The cost of contesting a board election is so high that competing slates are nominated only when a party seeks control of the company. In some companies, a director does not even need a majority of votes in order to take a seat on the board—in theory, a single vote is enough. In recent years, many companies have adopted "majority vote" arrangements whereby a director who fails to garner a majority of votes must offer his or her resignation to the board. The board then has a choice whether to accept or reject the nominee's resignation.

The other potential response for shareholders who disagree with management's political expenditures is to sell their shares. This response, however, will not influence management's

political expenditures, and indeed barely amounts to self-expression. If, say, Republican shareholders disapprove of management's use of corporate funds to support a Democratic candidate, their sales of shares will have no effect on management. Indeed, management will not even know the sales occurred. The shares will be bought by other investors who do not know of, or are not bothered by, the expenditures. Unless the expenditure is significantly bad for business, there will be no effect on the company's share price and therefore no influence on management before or after the fact. And if a political expenditure is materially bad for business, the share price will decline regardless of whether there are politically motivated stock sales.

Some might suggest a third avenue available for shareholders: they could sue management or the board for misuse of corporate funds for political activities. This avenue, however, is closed. Unless, self-dealing is involved, a court would dismiss the suit. State law protects management from suits that question management's business judgment. In my view, this is as it should be. Lawsuits are not an effective means of constraining political expenditures, now that the Supreme Court has allowed them.

In sum, the current corporate governance system provides essentially no opportunity for shareholders to influence or limit management's use of corporate for political activity. The system is not designed to give shareholders a direct voice in management decision making, nor should it be. The basic structure allows managers to manage, subject to market forces, and allows shareholders influence only a few fundamental decisions such as whether to acquire or be acquired by another company. The system reflects two assumptions: First, that shareholders have essentially uniform interests in having management maximize the return on their investment; and second that shareholders lack the expertise to manage the company.

From a corporate governance perspective, one could conclude that managers' political expenditures should be treated no differently from other expenditures—that is, allow the market to be the constraint. That view, however, would be a simplistic extension of the current regime to the post-*Citizens United* world. Shareholders are not uniform in their political views and will vary in their judgments regarding the use of a corporation's funds for political activities. Furthermore, there is no reason for them to defer to management on this dimension. The theoretical assumptions underlying the current corporate governance regime are not valid with respect to political expenditures by management.

Moreover, as a practical matter, there is no reason to expect shareholders to remain passive if management uses corporate funds for political activity. To the contrary, shareholders could well decide to use their annual vote for board nominees as a means of expressing their dissatisfaction with management's political expenditures. This could undermine the power of the shareholder vote as a means of disciplining business decisions.

Ideally, a shareholder vote for the board is based on the quality of management. Shareholders elect qualified board members who monitor management well, and so long as management is doing a good job, shareholders re-elect them. In recent years, shareholders have begun using their board vote to express dissatisfaction on particular governance matters such as staggered boards and executive pay. This is not necessarily bad, but if too many single-issue matters lead too many shareholders to withhold board votes, the function of a board vote as an indication of management's overall performance can become dissipated.

For companies that have majority vote regimes, the impact of "withhold votes" is more direct. If one or more director nominees fail to garner a majority of shareholder votes, how would the board respond to resignation offers if the votes withheld come from a mix of dissatisfaction with some business matters and some political matters? Let's say a vote for audit committee members comes to 40% of shares voted. Some of the withheld votes are assumed to reflect dissatisfaction with a financial restatement, other withheld votes are understood to reflect the company's poor performance, and yet others are understood to reflect dissatisfaction with management's use of corporate funds to run TV ads in support of a candidate that management believed would support policies that would help the company. Should the board accept or reject the resignation of the audit committee? The votes withheld for political reasons cloud the business message that shareholders have sent, and they fail to send a clear signal with respect to political expenditures. Making board votes a referendum on management's political expenditures is thus bad for corporate governance—bad for shareholders, board members, and managers alike.

*Citizens United* also creates complications for investors in creating an investment portfolio. From a financial perspective, shareholders should hold a diversified portfolio. Index funds are available as an easy means of doing so. But if shareholders want to disassociate themselves from companies that make political expenditures with which they disagree, they will have to put much more effort into maintaining a diversified portfolio. Purists will have to avoid index funds and carefully monitor the politics of companies in other types of funds. Funds may arise in response to *Citizens United* that will invest only in companies that commit to stay out of politics. But if not, shareholders will have to construct their own portfolios and monitor the political expenditures of the companies in their portfolios, selling some as political expenditures are made and rebalancing to maintain diversification. This problem is not overwhelming, but from a financial point of view, it is an unfortunate effect of *Citizens United*.

As the Supreme Court recognized, shareholders may want their corporations to engage in political activity, particularly when it promotes the business of the corporation. But when the financial benefits of political activity are small, or if shareholders' concerns for the public good outweigh their private interests as investors, shareholders may want the corporation to remain silent. From the perspective of both constitutional law and corporate governance, shareholders

should be empowered to make that decision in a way that does not imbalance the overall corporate governance system.

How can that happen? I propose that corporations be required to let shareholders vote annually on whether they want their company to exercise the rights that *Citizens United* gave them. Managers who seek shareholder approval of political expenditures would use this opportunity to explain the expenditures they intend to make, how those expenditures would be in shareholders' interests, and what the cost will be. This need not be a line-item disclosure, just a description of the types of expenditures management anticipates and the reasons for those expenditures. Some companies may choose to stay out of politics. Others, such as media companies, may ask shareholders for a blank check in order to keep complete control of content and creativity. The objective is only to have managers make their case to shareholders, and allow shareholders to decide whether to approve management's proposal. This vote would be separate from the vote for board nominees. Shareholders would be able to express their views on politics separately from their views on how well the directors are doing at monitoring management performance.

This mechanism is not perfect. Shareholders will still differ in their political views and, as in any system of majority rule, the minority can be disappointed. Some disappointed shareholders might chose to divest shares in companies for political reasons. Shareholder approval would, however, induce management to focus corporate political activities on promoting shareholders' economic interest and thereby limit discontent to some degree. Although some shareholders may still vote against incumbent board nominees on political grounds, they would have the option to elect good business people to the board and at the same time constrain management's use of corporate resources for political activities.

Thank you. I look forward to your questions.

## Annex A

### Corporate Speech and Corporate Governance

**Ronald J. Gilson and Michael Klausner**  
**(Forthcoming Forbes Magazine, March 11, 2010)**

On Jan. 21 the Supreme Court ruled that the government can no longer ban corporate funding of politicians during candidate elections. The *Citizens United* ruling says that the First Amendment protects political speech by corporations—including publicly held corporations. But if corporate speech consists of managers using corporate funds to engage in political activity that shareholder finds objectionable, what can a shareholder do?" Vote against the board? Sell his or her shares?

Congress is currently considering a range of potential legislation in response to the Court's ruling. In our view, a simple modification in the way public companies are governed will reduce the likelihood of turmoil in board elections and confusion in investment decisions: Require corporations to let stockholders vote annually on whether their corporation will engage in political activity and if so, what types of activity.

Under existing corporate law, stockholders' ability to influence how management runs the corporation's business is limited largely to annually electing a board of directors. Stockholders' interests are understood to be solely financial: Management maximizes the return on stockholders' investment, and stockholders pass judgment on management performance when they elect directors. When stockholders share this common concern with profits a simple governance system serves them—and the economy—well.

But stockholders do not have a common interest in political activity. Stockholders who seek the same profits from an investment may be Republicans or Democrats or Independents. They may be pro-choice, pro-life, pro- or anti-health care reform. A stockholder of, for example, a pharmaceutical company may even oppose a politician who promises to favor the pharmaceutical industry due to the politician's views on financial sector reform.

The Court in *Citizens United* said that "stockholders can determine whether their corporation's political speech advances the corporation's interest in making profits." Once stockholders have made that determination they can vote against the company's incumbent board, or they can nominate board candidates whose political views they like. But do we want board elections to become referenda on management's political speech? Politicizing corporate elections will be bad for stockholders, managers and the economy.

Stockholders' other alternative is to sell their shares. But investment experts advise investors to hold diversified portfolios. *Citizens United* should not complicate stockholders' investment strategies with politics.

As the Supreme Court recognized, stockholders may want their corporations to engage in political activity, particularly when it promotes the business of the corporation. But when the financial benefits of political activity are small, or if stockholders' concerns for the public good outweigh their private interests as investors, stockholders may want the corporation to remain silent. From the perspective of both constitutional law and corporate governance, stockholders should be empowered to make that decision.

How can that happen? Congress should pass legislation requiring corporations to let stockholders vote annually on whether they want the company to exercise the rights that *Citizens United* gave them, either directly or by providing corporate funds to another entity. Managers who seek stockholder approval of political activity would use this opportunity to explain the actions they intend to take, how those actions would be in stockholders' interests, and what the cost will be. Managers would make their case to stockholders, who would then decide whether to approve management's proposal.

This mechanism is not perfect. Stockholders will still differ in their political views and, as in any system of majority rule, the minority can be disappointed. Stockholder approval would, however, induce management to focus corporate political activities on promoting stockholders' economic interest. Equally important, it would separate votes for board seats from votes on management's political activities. Although some shareholders may still vote against a board on political grounds, they would have the option to elect good business people to the board and at the same time constrain management's use of corporate resources for political activities. Finally, stockholders would be less likely to combine investment decisions with political decisions.

To be sure, political contributions are not the only corporate action that may divide shareholders. For example, corporations also make charitable contributions. Typically these are uncontroversial. They engender community goodwill by providing support to community institutions like schools, art museums and symphonies, and they sometimes enhance a corporation's image in a manner similar to advertising. But a willful CEO certainly can also use corporate funds to make contributions to her favored causes or causes that gain her personal notoriety. Why doesn't this behavior warrant a separate governance mechanism? The short answer is that this type of misbehavior represents a small part of charitable giving and, like other self-interested behavior by CEOs, is adequately constrained by ordinary board oversight. In contrast, all direct political activity by a corporation risks dividing shareholders and politicizing board elections. A different corporate governance mechanism is therefore required.

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