Commentary on Brudney and Ferrell

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Brudney and Ferrell's excellent article makes an important contribution to the ongoing debate over the legitimacy of corporate charity. They are concerned that corporate managers donate money to charities without shareholder consent, and they propose that federal tax law only allow a corporation to deduct charitable donations if its shareholders choose the recipients.

This Comment is divided into two Parts. Part I discusses the practicality of implementing this proposal and possible collateral effects. Part II discusses problems that Brudney and Ferrell identify with unfettered management discretion in charitable giving, the seriousness of these problems, and whether they could better be addressed in other ways.

I. IMPLEMENTING THE BRUDNEY-FERRELL PROPOSAL

A. Reduced Advertising Value of Corporate Donations

Beneficence is only one objective of corporate charity. Another objective is advertising for the corporation, for its managers' social reputations, or for both.[1] Shareholder-designated donations ("shareholder donations") will usually have less advertising value than manager-designated donations ("manager donations"). First, as Brudney and Ferrell point out, managers can coordinate donations strategically, whereas shareholders usually cannot.[2] Donations that enhance the corporation's reputation with nonshareholder constituencies—customers, suppliers, community activists, and government officials—are easier for managers than shareholders to identify, and managers

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1 See John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 Wake Forest L Rev 657, 678 (2001) ("[A]vailable evidence indicates that, in fact, corporate managers view charitable contributions as consistent with a profit-maximization strategy, with the corporation benefiting from the 'advertising' or 'halo effect' of contributions.").

2 See Victor Brudney and Allen Ferrell, *Corporate Charitable Giving*, 69 U Chi L Rev 1191, 1196–97 (2002). Compare Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U Chi L Rev 1103, 1117 (1969):

> Managers are more likely than shareholders to be aware of what legislation will benefit or harm the corporation. Thus, for all the same reasons that shareholders delegate decision-making authority regarding ordinary business judgments to managers, they might also want to delegate authority to make political interventions.

are more likely to assess the relative importance to the corporation of competing causes. Second, because shareholders of most public corporations are widely dispersed, they are not as likely as managers to donate to charities located where the corporation does most of its business and where donations usually have the highest advertising value. Third, managers receive less advertising for their own social reputations from shareholder donations, whereas shareholders are not likely to realize correspondingly more advertising value. There is thus a deadweight loss from an advertising perspective (managers may shift some of this loss to the corporation by demanding increased compensation or other perks). To the extent managers could have used their social prestige from donations to advance the corporation's agenda, the corporation is worse off as well.[3]

B. Reduction of Corporate Donations

Managers who cannot control corporate donations might respond by reducing or eliminating them. Managers might spend the money instead on business-related projects that enhance their own business or social prestige, even if these projects are potentially more costly to the corporation.[4] If corporate charitable giving is on the whole beneficial to corporations or at least socially beneficial, any such reduction or elimination of corporate charity would be a social cost of the Brudney-Ferrell proposal.

C. Controversial Charities

Corporate donations are even more likely to be reduced or eliminated if shareholders choose controversial charities. Controversial charities could also spark costly infighting within a corporation. If, for example, some shareholders select pro-labor or pro-environment causes, managers may respond by eliminating charitable expenditures, even though most of the corporation's shareholders designate ideologically neutral charities. Alternatively, managers (who own 10 per-

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3 Social connections from charitable endeavors, however, can increase managers' loyalty to each other at the expense of shareholders. Indeed, one of the most controversial deals in corporate law, the sale of the Trans Union Company by its Chicago-based management to the Pritzker family, was signed at the Chicago Lyric Opera Ball. See *Smith v Van Gorkom*, 488 A2d 858, 869 (Del 1985). This venue was chosen even though the rushed signing at a black-tie event underscored, symbolically at least, the relative paucity of investigation and deliberation by Trans Union's board. See comments made by Robert Pritzker in *Roundtable Discussion: Corporate Governance*, 77 Chi-Kent L Rev 235, 239 (2001) (responding to this criticism at the venue by saying "I hate the opera.").

4 For example, managers might enhance their own social prestige by causing the corporation to spend money buying a sports team, an auction house or some other "prestige" business. Unless accomplished through a merger, most such transactions would not require shareholder approval.

cent or more of the stock in many companies) might respond by requesting that their own shareholder donations go exclusively to ideologically driven charities on the opposite side of an issue from activist shareholders. Shareholder donations to nationalist charities (for example, pro-Palestinian or pro-Israeli) could have a similar effect, particularly if a charity is extremist.[5]

Finally, Brudney and Ferrell acknowledge that their proposal would bring the combustible issue of religion into deliberations over corporate charity.[6] Indeed, their only prediction of distributional change is that there would likely be an increase in corporate donations to religious causes and a reduction in donations for educational and cultural organizations.[7] Religious donations, however, could undermine corporate culture if employee religious preferences differ from those of shareholders, and resultant disputes could diminish shareholder wealth. It is true that corporate managers (probably in order to avoid controversy) discriminate against religious charities that are widely supported by individuals in the general population, and perhaps this ought to be compensated for. Religious and other charities favored by individuals, however, could be compensated for lost corporate contributions with simpler changes to the Internal Revenue Code, such as restoration of the charitable deduction for nonitemizers.[8] If church and state are not a good combination, church and corporation may not be much better.

D. Evasion Strategies

Evasion strategies are abundant, and some could be costly to the corporation, to society, or to both. Managers could raise salaries of officers on the understanding that they will make individual contributions to certain charities.[9] Managers could give corporate business on favorable terms to suppliers and customers that donate to favored charities. Managers could cause the company to enter into a contract, such as a consulting arrangement, on favorable terms with a charity it-

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5 How, for example, should managers deal with a request from a large Middle Eastern institutional shareholder that the corporation donate to a charity with alleged ties to terrorism? Probably by doing away with charitable donations altogether.

6 See Brudney and Ferrell, 69 U Chi L Rev at 1215–16 (cited in note 2).

7 See id.

8 The impact on specific religious organizations, however, would differ. Religions preferred by the well-to-do (who tend to own more stock) would benefit most under the Brudney-Ferrell approach. Religions preferred by the less well-off would benefit most from restoration of the charitable deduction for nonitemizers.

9 The corporation, however, would lose its business expense deduction for salaries that exceed $1 million. Robert Sitkoff has noted an identical evasion maneuver concerning the analytically similar problem of corporate speech. See Sitkoff, 69 U Chi L Rev at 1136 & n 135 (cited in note 2).

self.[10] Ideologically oriented donations could be cast as business expenses and funneled through trade associations. Scientific or sociological research that benefits the corporation could be done through a joint venture with a university, medical center, or other organization instead of through charitable donations (the recipient would probably have even less control over the project than it would if the research were funded through a charitable donation).[11] Finally, conventional advertising is a close substitute for charitable donations such as corporate sponsorship of television dramas, opera broadcasts, symphony performances, museum exhibits, and the Olympic Games. Conventional advertising, however, would diminish the value of corporate support if it made these events less enjoyable for viewers and patrons (in order to retain corporate sponsors, museums might have to accommodate billboards similar to those in train stations and public television might have to take commercial advertising).

E. Administrative Costs

Administrative costs associated with the Brudney-Ferrell proposal could be substantial. Shareholder views on charitable expenditures, if solicited annually, would probably be solicited at the same time as proxies. Proxy mailings thus would be more expensive. The most significant cost, however, would be incurred if shareholders were not to devote correspondingly more time to their proxy materials. If shareholders spend time designating charities instead of thoughtfully addressing other more important issues, such as takeover defenses and election of directors, there could be a decrease in shareholders' overall role in corporate governance.

Brudney and Ferrell recognize that shareholder donations would also have to be made on behalf of stock held by pension funds and mutual funds.[12] There are two principal alternatives: (1) allow fund managers to designate charities on behalf of shares in their funds, which would give enormous giving-power to these managers and thus

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10 Such a contract would not be subject to increased scrutiny unless a director of the corporation were also a director of the charity, and even in these circumstances approval by the corporation's disinterested directors would probably make the transaction immune from attack. See 8 Del Code Ann § 144 (2001); Model Business Corporation Act § 8.60 (1998).

11 This approach has some pitfalls. Research may not qualify as a deductible business expense if it is too broad or unrelated to a corporation's business. Also, a corporation may want to avoid the legal consequences of directly sponsoring research that concludes with adverse findings about the corporation's products or policies. For example, a tobacco company that wants to support research in hospitals and universities on the health effects of smoking is likely to prefer funding the research through a separate trade association or through a charitable foundation. The purpose would be to avoid legal attribution to the company of a later finding by researchers that smoking is indeed harmful to human health.

12 See Brudney and Ferrell, 69 U Chi L Rev at 1217 (cited in note 2).

defeat the objective of the Brudney-Ferrell proposal, or (2) allow participants to designate charitable contributions according to their share in the overall fund (for defined contribution plans, each participant's share would have to be calculated using a formula similar to that used to calculate benefits). The overall allocation of charitable gifts chosen by the fund's participants would then be designated by the fund's managers for each corporation in which the fund owned stock. Whichever approach is chosen, it would add to the cost of administering the fund and probably result in higher fees.

Finally, charities might spend considerable sums competing with each other for shareholder donations, and perhaps even launch advertising campaigns around the time of year in which corporations solicit shareholder donations. Overhead for charitable organizations would rise and results might be skewed in favor of large charities that can afford advertising campaigns. Excessive competition for shareholder donations could also backfire and reduce overall public support for charities. Regulators would also have to decide whether communications to shareholders about charitable donations from management, from other shareholders, or from charities themselves should be subject to regulation similar to that imposed for solicitation of proxies. An affirmative answer to this question would raise costs associated with shareholder donations considerably.

II. Underlying Problems with Manager Donations and Alternative Solutions

Brudney and Ferrell expose troubling concerns about a system in which corporate charity is dominated exclusively by manager donations. Some aspects of manager donations are not so serious, but others should be addressed, whether with the Brudney-Ferrell proposal or through other remedies.

A. The Corporate Waste Problem

Some corporate charity, despite its advertising value, is not worth it from the corporation's perspective. Although donations of reasonable amounts do not meet the classic definition of waste, some corporate charity might come close to meeting the "proportionality" test for waste applied by a few courts to executive salaries and other decisions tainted with director self-interest (but almost never to corporate charity).[13]

[13] See, for example, *Lewis v Vogelstein*, 699 A2d 327, 336 (Del Ch 1997) (discussing proportionality and classic waste standards as applied to executive compensation).

The waste problem is, however, more apparent than real. First, when the importance of corporate relations with nonshareholder constituencies is taken into account, charity can be more valuable to a corporation than it at first appears. Second, donations benefit corporations collectively by reducing political pressure to raise corporate income taxes or to regulate conduct of corporations. Free-rider problems abound, however, because these benefits are unlikely to be realized unless a large number of corporations make donations. If most corporations were private and the money that managers gave were their own, these free-rider problems might frustrate collective efforts to use charitable donations as a way to improve the image of corporations in the public eye. Agency problems in public corporations arising from the fact that shareholder money is involved, on the other hand, could actually *raise* total corporate charity to the welfare-maximizing level for corporations as a whole.

Finally, from a social welfare maximization viewpoint, the corporate waste problem fails the "so what?" test. Even if corporate assets are donated at the expense of shareholders, government intervention is probably justified only if recipient charities spend the money in ways that are less socially useful than the ways in which shareholders would spend it themselves.

B. The Allocation Problem

Brudney and Ferrell identify an allocation problem: corporate charitable giving is slanted in a direction that does not reflect charitable priorities of shareholders or society as a whole. This allocation problem could take several forms. First, managers may not allocate charitable donations the way they would if the money were their own (a "Trustee Problem").[14] The Trustee Problem would be serious if statistical evidence showed a large difference between giving by publicly held and privately held corporations. Even if there were such a difference, however, donations made by dispersed shareholders may not better reflect what managers would have done with their own money than decisions made by managers themselves.

Second, managers may not allocate donations the way shareholders would if they were fully informed and could overcome collective action problems (an "Agency Problem"). The Agency Problem is addressed by the Brudney-Ferrell proposal, although managers, not shareholders, still decide how much money is donated. Shareholder

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14 In essence, the managers are not following the "prudent man rule," which requires a trustee to manage property entrusted to him as he would manage his own property. This strict standard, however, is rarely applied to managers of corporations, who instead are governed by the presumptions of the business judgment rule.

donations, on the other hand, might make the Agency Problem worse if shareholders lack information about other shareholders' donation decisions. Information and collective action problems are common when individuals donate their own money, as shown in the weeks after September 11, 2001, when excess blood was given to the Red Cross and many people cut back on their usual charities to donate to relief funds amassing almost one million dollars per victim. Shareholders might make even less effort to educate themselves before donating corporate funds. Finally, a shareholder donation designation process cannot respond as quickly as managers (and shareholders of privately held companies) to disasters and other sudden charitable needs. For all of these reasons, it is not at all certain that the Brudney-Ferrell proposal would approximate any closer than the existing regime the donative decisions that would be made by an informed and coordinated body of shareholders.

Finally, managers might not allocate donations in a manner that maximizes social benefit (a "Social Welfare Maximization Problem"). The Social Welfare Maximization Problem is the most serious one because corporate managers probably do not donate to charities where an additional dollar is most needed. This is also, however, the most difficult problem to solve because individual donors do not necessarily do a better job of maximizing social welfare, and uncoordinated decisions by shareholders might be even less likely to meet this goal.

Furthermore, even without a system of shareholder donations, shareholders can address the Social Welfare Maximization Problem by adjusting their own personal donations ex post to take into account corporate contributions. Government also can adjust spending to favor causes disfavored by corporations. Government can spend less, for example, on arts and private educational institutions that receive corporate giving and spend more on public education and health organizations that receive fewer corporate donations. There is some evidence that government is already doing this—federal arts funding is lower per capita in the United States than in most other countries, yet corporate giving to the arts is higher. Government can go even further in this direction, perhaps by reducing National Endowment for the Arts funding for prestigious opera companies and symphonies that attract corporate sponsors and spending more money on arts education in public schools.

The Brudney-Ferrell proposal thus is most likely to benefit causes that are unlikely to be funded either by corporations or by government, but that would be supported by individual shareholders. Religious organizations would probably top the list. Here again, however, government can indirectly subsidize individuals' donation decisions through tax deductions or credits, and to some extent government already does (for taxpayers who itemize deductions). Government could do more. For example, allowing individuals to deduct charitable donations regardless of whether they itemize deductions would significantly help religious organizations and other charities favored by broad spectrums of the public. A full or partial tax credit for individual donations would do even more for charities favored by lower and middle income individuals. Such changes to the tax code would have the advantage of accommodating the charitable preferences of less wealthy individuals, whereas these same individuals would have a minimal role in the shareholder donations proposed by Brudney and Ferrell. Distributive goals could be met by paying for individuals' charitable tax breaks with modest increases in corporate taxes, limitations on deductions for corporate donations, and/or less generous tax breaks for capital gains.

C. The Ideologically Motivated Giving Problem

Another problem pointed at by Brudney and Ferrell is that corporations give money to organizations that promote corporate interests (usually in low taxation, little regulation, and free trade) that arguably conflict with the public interest. Individual shareholders, they point out, might be less likely to donate to such organizations, even if their work made the corporation better off.

This problem is the opposite of the corporate waste problem of gifts that have little or no benefit for the corporation. Through these gifts, corporate managers are doing what they do in many other ways with tax deductible dollars, whether through lobbying, litigation, advertising, public relations, or trade and industry groups (campaign contributions are the only significant such expense that is not tax deductible). These efforts all promote the corporation's interests in the public arena. Arguably, "charitable" contributions to some policy-oriented groups (free market think tanks, etc.) should as a matter of tax law be deductible only as business expenses because that is what they really are, but such a distinction should hardly turn on whether shareholders approve (a closely held timber company's contribution to a "wise use" environmental group has the same impact on public debate about the environment as a similar contribution by a publicly held timber company). Drafters of the tax code decide how much self-interested speech of this sort is subsidized (whether as charitable or business expenditures), but this decision should turn on assessment of how much self-interested speech by corporations is in the public interest, not on whether it is approved by shareholders.

Furthermore, speech is best confronted with more speech. Government already subsidizes organizations that critically examine claims of pro-corporate charities and speak out on the other side of environmental, labor, tax, and other issues. Contributions to the Sierra Club and Common Cause are tax deductible. Academic research rebutting corporate claims on topics such as global warming is done at public universities. These universities are supported even though political views and other biases of professors and researchers do not necessarily correlate with those of taxpayers (and perhaps even less so if the amount of taxes paid were used as a proxy for a taxpayer's "share" in public expenditures). Indeed, individual taxpayers usually have no direct voice in how expenditures on research, education and other public interest activities are made.[15] It would be more worrisome if biases in the work of publicly funded research and education institutions correlated positively with biases in research and education funded by corporate charitable donations, but such is usually not the case. If, however, corporate speech (whether through charitable donations or other expenditures) excessively influences public perceptions of important issues, government can respond by taxing corporations more and increasing government funding of organizations with a different perspective.

D. The Conflicts Problem

Corporate charitable donations can create conflicts of interest between directors and the corporation. Most conflicts are variations on the allocation problem (directors steer corporate gifts toward their favorite charities rather than toward charities most likely to benefit the corporation or society). Another type of conflict emerges, however, when independent directors are officers of charities that receive donations from the corporation. Although these donations are legally "cleansed" if directors affiliated with the charity recuse themselves from board deliberations on the donations, these directors do not recuse themselves from overseeing conduct of the directors and officers who do determine the donations. Donations to independent directors' charities could implicitly depend on their exercising general oversight functions in a way that pleases management. Indeed, a corporate board could be stacked with seemingly "independent" directors (such as university, museum, and hospital administrators) whose charitable organizations depend on inside directors' approval of cor-

15 Federal expenditures generally are not allocated based on the opinions of individual taxpayers. The only exception—and indeed a good analogy to the Brudney-Ferrell proposal for shareholder selection of corporate charities—is the choice taxpayers have to allocate part of their tax payment to federal financing of elections. Sometimes, government expenditure decisions are made at the local level by taxpayers collectively (for example, voting on a referendum or school bond issue), but usually such decisions are made by legislators who are subject to the discipline of the electoral process if they allocate funds differently than voters would prefer.

porate donations. As the recent Enron scandal demonstrates, such compromise of oversight functions can be disastrous.[16]

Probably the most significant benefit from the Brudney-Ferrell proposal is that it would lessen inside directors' influence over independent directors who are affiliated with charitable organizations.[17] Arguably, this same result could be reached more simply by barring a corporation from donating to a charitable organization of which one of its directors is an officer or employee.[18] Whether the Brudney-Ferrell proposal, a ban on corporate gifts to charities that employ directors, or some other approach is implemented, this aspect of corporate charity, particularly in the aftermath of Enron, urgently needs to be addressed.

E. The Disclosure Problem

Even if the Brudney-Ferrell proposal is not adopted, charitable donations should be disclosed fully to shareholders. This author[19] and others have urged the Securities and Exchange Commission to require that corporate charity be subject to disclosure requirements under federal securities laws. Particularly because there is not necessarily a benefit to the corporation, all charitable gifts in excess of a nominal amount should be presumed material. Such disclosure should conspicuously appear under a separate heading in registration statements filed under both the 1933 Securities Act for sales of new securities and under the 1934 Securities Exchange Act's periodic disclosure requirement. Disclosure should include a detailed list of recipient charities, the amount donated and whether any of the corporation's directors are affiliated with those charities. Shareholders may not have the right to select the recipients of corporate charity; they should have the right to know who these recipients are and about any relationship the recipients have with management.[20]

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16 At least three independent directors of Enron were affiliated with charities that received large donations from the corporation. Some of these independent directors' exercise of their oversight functions has subsequently been called into question.

17 The Brudney-Ferrell proposal would not be a perfect solution to this problem because inside directors would in many cases still have the power to terminate the corporation's charitable giving altogether if an independent director affiliated with a charity chosen by shareholders displeased management.

18 A broader ban—and probably one that most corporate managers and major arts and educational institutions would consider unreasonable—would also encompass donations to any charity of which one of the corporation's directors was a director or trustee.

19 See Letter of Comment from Richard W. Painter to Jonathan Gottlieb, Division of Corporate Finance, U.S. Securities and Exchange Commission (Apr 3, 1998) (on file with author) (suggesting that disclosure of corporate charitable contributions in securities filings ought to be mandatory).

20 See Sitkoff, 69 U Chi L Rev at 1110 n 28 (cited in note 2) (discussing ways in which "[d]isclosure and the ensuing disciplining force of the market dominate governance mechanisms

CONCLUSION

Shareholders should have a voice in some important corporate decisions. They already do in such matters as merger, sale of all or substantially all assets, election and removal of directors, reincorporation, amendment to the articles of incorporation, and dissolution. Professor Ferrell has cogently argued with another coauthor that shareholders should have a say ex ante in rules that govern defenses against hostile takeovers.[21] Others have proposed that target company shareholders be allowed to veto ex post over the Internet antitakeover defenses as soon as a tender offer is made and defenses are implemented.[22] Shareholder ratification should also perhaps be required for executive salaries that exceed a certain level. Many such proposals are more practical now than they once were because the Internet makes shareholder voice in corporate governance both easier to exercise and economically feasible. The time is thus ripe to revisit the question of shareholder voice in corporate governance, and the relative lack thereof in the United States compared with many European jurisdictions that require managers to consult shareholders on a wider range of matters. The argument that leaving most decisions to managers is more expedient and allows the corporation to respond more quickly to changing circumstances may not hold sway much longer.

Corporate charity, however, is not a matter of critical importance relative to other areas where shareholders have no voice. The economic costs of implementing a system of shareholder donations would probably outweigh the benefits. The political cost is perhaps the most significant, because shareholder democracy concerning corporate charity, if it comes at all, could come at the expense of expanding shareholder democracy in areas that are more important. Other areas in corporate governance (for example, defensive measures against corporate takeovers, and perhaps salaries of officers and directors) are more prone to abuse than charitable donations. It is in these areas that efforts to expand shareholder democracy should begin.

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such as submission of specific expenditures to a shareholder vote").

21 See Lucian Arye Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va L Rev 111, 143–49 (2001).

22 See Christian Kirchner and Richard W. Painter, *Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive, and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 Am J Comp L (forthcoming 2002); Christian Kirchner and Richard W. Painter, *Towards a European Modified Business Judgment Rule for Takeover Law*, 1 Eur Bus Org L Rev 353, 362 (2000).

SYMPOSIUM: MANAGEMENT AND CONTROL OF THE MODERN BUSINESS CORPORATION

CLOSING REMARKS