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December 13, 2001

Alfred M. Pollard, Esquire
General Counsel
Office of Federal Housing Enterprise Oversight
Fourth Floor
1700 G Street, NW.
Washington, D.C. 20552

Re: 12 CFR Part 1710

Dear Mr. Pollard:

I have been asked on behalf of the Federal Home Loan Mortgage Corporation ("Freddie Mac") to comment on certain proposed regulations submitted for public comment by the Office of Federal Housing Enterprise Oversight ("OFHEO") (66 *Fed. Reg.* 47557 (Sep. 12, 2001) (the "Proposal")). Because of my experience with the subject of corporate governance,[1] I have been asked to comment upon legal and policy issues presented by those aspects of the Proposal that would purport to establish "minimum corporate governance practices and procedures" of Freddie Mac and the Federal National Mortgage Association (collectively, the "Enterprises").

For the reasons explained more fully below, I believe that the putative "minimum

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[1] Please see the Attachment to this letter for a brief summary of my professional experience.

corporate governance practices" embraced by the Proposal are not "minimum" at all, and would effectively supplant the complex, dynamic and subtle web of corporate governance constraints which existing law provides to encourage prudent corporate management without unduly discouraging capable persons from serving as directors. Such a jump shift in the situs and content of corporate governance rules would come at the expense of predictability, fairness and efficiency. That adverse result cannot be avoided with modest tinkering with a few scattered terms of the Proposal; it can only be avoided by adopting an entirely different approach. My reasoning follows.

Essential Goals and Structure of Existing Corporate Governance Law

I begin by identifying the goal I believe any system of corporate governance law should serve: namely, to encourage the unselfish participation of qualified persons as the corporation's managers -- notably its board of directors -- so as to enhance the value of the corporation to its stockholders and the communities it serves. The existing system of corporate governance for large, publicly held American corporations serves this overriding goal of corporate governance law in a highly complex, subtle way; and this is no less true of organizations such as the Enterprises that are subject to considerations of safety and soundness under federal law. Our country's system of corporate governance is an intricate web of state and federal legal rules, rules of self-regulatory organizations such as the New York Stock Exchange, relevant labor, financial and product markets, and the culture of corporate managers, all developed in

incremental steps over the last century.

Within this web, the legal controls that define the managerial responsibilities and liabilities of the directors to the corporation and its stockholders have been supplied almost exclusively by the law of the State in which the corporation is incorporated.[2] Stock exchange rules now supplement the basic state law scheme of corporate governance controls in important but very limited ways, such as establishing requirements for audit committees of the board of directors to assure independence and competence.[3] The legal rules that govern the fiduciary duties of directors and the directors' potential liability for breach of those duties remain, however, essentially a matter of state law. As the United States Supreme Court has made clear, these state law rules control even with respect to federally chartered firms, in the absence of Congressional specification to the contrary.[4]

I am not aware of any instance in which a United States agency has previously exercised supervisory authority over a federally created enterprise to promulgate

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[2] *See, e.g., CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 89-90 (1987).

[3] Those rules of the New York Stock Exchange are of course applicable to Freddie Mac, securities of which are listed for trading on that exchange.

[4] In an example of such overriding specification, Congress has established a minimum standard of liability for inattention and lack of care for directors of federally insured banks. *Atherton v. FDIC*, 519 U.S. 213, 226-227 (1997), *citing* 12 U.S.C. §1821(k).

binding rules of director responsibility and liability; the one instance of which I am aware in which such a proposal was made ended in withdrawal of proposed rules of director conduct from the regulations as finally adopted.[5] In withdrawing its original proposed rules of director conduct, the Office of the Controller of the Currency prudently "acknowledge[d] the limitations inherent in crafting a regulation in this complex area that is not overly detailed yet provides directors with clear and useful guidance as their responsibilities." 61 *Fed. Reg.* at 4855. Indeed, an agency sensitive to the scope of its institutional competence should be reluctant to regulate in "this complex area" of director duties and liabilities that has evolved gradually and with much greater experience in state courts and legislatures.

Uncertainty Regarding Applicable Corporate Governance Law

Predictability -- an important goal in corporate governance as in commercial affairs generally -- would be impaired by the Proposal because of its profound ambiguity concerning the source of governing law. On one hand, the Proposal would invite each of the Enterprises to "elect to follow and be bound by the corporate governance practices and procedures" of the Delaware General Corporation Law, the

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[5] *Compare* 60 *Fed. Reg.* 11924, §§7.2000 *et seq.* (March 3, 1995) (proposed corporate governance regulations issued by the Office of the Comptroller of the Currency with respect to national banks) *with* 61 *Fed. Reg.* 4849, 4854-4856 (Feb. 9, 1996) (final rule withdrawing proposed specific requirements for director conduct in favor of "a general statement that the business and affairs of the bank shall be managed by or under direction of the board of directors.").

Model Business Corporation Act ("MBCA") or the State (in the case of Freddie Mac, Virginia) in which the corporation's principal offices are located. (Proposal §1710.10(a)). At the same time, however, the Proposal would enact regulations purporting to define sweeping duties for directors, with the force of law and subject to enforcement through fines or civil penalties for noncompliance.

The resulting legal tension is palpable, in many ways. For instance, provisions of the Delaware General Corporation Law and the Model Act exonerate directors who reasonably rely upon a report by a committee of the board of directors.[6] Beyond any doubt, these statutes are fundamental rules of corporate governance and practice, since they expressly sanction and facilitate specialization of function within the board of directors.[7] The frequency of judicial reliance on such statutes testifies to their importance.[8] The Proposal, however, would dictate that "[n]o committee of the board of

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[6] 8 *Del. C.* §141(e); MBCA §8.30(d), (e)(3).

[7] *See* Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 395 (1997) (protection of directors' good faith reliance on board committees and reports of officers or experts is "[a] significant element of corporate governance in Delaware, and in many other jurisdictions ... ."); 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §4.01(b) comment at 170 (1994) ("Directors who do not serve on a given committee will often have to rely on the committee's work product, its performance (*e.g.* with respect to its ongoing oversight of particular areas), and its decisions and judgments with respect to procedural and substantive matters.").

[8] *See, e.g., Brehm v. Eisner*, 746 A.2d 244, 261-262 (Del. 2000), and cases cited in I DENNIS J. BLOCK, *et al.*, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS at 203 n. 438 (5th ed. 1998).

directors ... shall operate to relieve the board of directors or any board member of any responsibility imposed by applicable laws, rules, and regulations." (Proposal §1710.11(a)). Would this provision preclude application of the fundamental state laws permitting and protecting director reliance on committee work? And, who would decide this unsettled and unsettling question, and when?

Displacement of the Business Judgment Rule

Perhaps the most important tension -- and resulting uncertainty -- that would arise from the Proposal is the relation between its standards for director conduct and the long-standing "business judgment rule" developed by the state courts to define and limit director liability for lack of care. The "business judgment rule" -- a principle of common law dating back to the early 19th Century or before[9] -- protects disinterested and independent directors from liability for their good faith decisions as directors.[10] In the face of such a corporate governance rule, it is hardly surprising that cases holding disinterested and independent directors personally liable for their decisions are few and far between. In contrast, the Proposal appears to impose conduct requirements upon directors that could result in liability without regard to good faith. (Proposal

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[9] BLOCK, *supra*, at 9-11.

[10] ALI PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) §4.01(c); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1983); Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 BUS. LAW. 2065, 2071-72 (1990). *See also* MBCA §8.31.

§§1710.20, 1710.21). There is no suggestion in the Proposal that disinterested directors will be free from personal liability for their decisions if they simply act in good faith; to the contrary, the Proposal articulates far more demanding standards, which are enforceable through civil monetary penalties based on after the fact assessments of their conduct.

Thus, the Proposal is entirely schizophrenic: while purporting to direct the Enterprises to elect to be bound by state law "corporate governance practices and procedures" -- and surely no such "practice and procedure" is more settled and fundamental than the "business judgment rule" -- the Proposal at the same time appears to contemplate potential director liability for conduct that the "business judgment rule" itself would clearly protect.

Lack of Substantive Predictability

Not only would the Proposal undermine the predictability of existing corporate governance laws by creating uncertainty about what laws apply, it would also impair predictability in at least one other important respect. Particularly in its provisions addressing the conduct and responsibilities of directors, the Proposal in numerous respects identifies duties using terminology that it does not define and that has essentially no settled meaning in the field of corporate governance.

In §1710.20(a) of the Proposal, for example, each director is charged with the duty to act "with due diligence." "Due diligence" is not a defined term in the Proposal.

It is not in my opinion a defined term in existing corporate governance law either. To the contrary, it is a term most generally used in the law of director duties to refer to the obligations of those whom Congress has explicitly made responsible for ensuring the accuracy of disclosures to investors in connection with public offerings of securities.[11] In other words, "due diligence" is a term of art drawn from and applicable in a field entirely different from the field of general director managerial responsibilities to the corporation and its stockholders; it has no accepted or predictable meaning as a standard of director conduct and only engenders confusion in that context.

The same section of the Proposal that requires "due diligence" also charges directors of an Enterprise with the duty to act "[o]n a fully informed ... basis." Read literally, this requirement means that directors are potentially subject to civil penalties if they make any decision without knowing all material facts, regardless of the good faith nature of their actions. One suspects that this is not the intent of the provision, yet on its face the provision appears to be in sharp conflict with established state law governance standards, which preclude director liability for decisions predicated upon subjectively reasonable -- even if ultimately incomplete -- efforts to become informed.[12]

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[11] *See, e.g.*, HAFT, DUE DILIGENCE IN SECURITIES TRANSACTIONS (1996); 15 U.S.C.A. §77k; *Escott v. BarChris*, 283 F. Supp. 643 (S.D.N.Y. 1968).

[12] The Model Act, for example, allows for director liability for lack of care only where "the director was not informed *to an extent the director reasonably believed appropriate in the circumstances*." MBCA §8.31(a)(2)(ii)(B) (emphasis added). *See also Brehm v. Eisner*, 746 A.2d at 259 (satisfaction of "the informational component of

In its present format, then, the Proposal purports to establish potential liability under a standard ("fully informed") that cannot plausibly be read literally and yet that exists in a legal vacuum[13] such that it cannot confidently be read any other way.

Even more foreign to settled rules of corporate governance are the requirements of Section 1710.21 of the Proposal imposing responsibility upon the directors to "ensure that the Enterprise is operated in a safe and sound manner ... ." On a literal reading, this formulation would appear to render the directors insurers against any failure of the Enterprise to meet standards of safety and soundness. That remarkably broad and strict reading is, if anything, further supported by the remarkable scope of the individually specified responsibilities that are "includ[ed], at a minimum," within the overall duty to "ensure" "safe and sound" operation of the Enterprise. Thus, for instance, the duty to "ensur[e] the integrity of the accounting and financial reporting systems of the Enterprise" and to ensure that "appropriate systems of control are in place to identify and monitor risk and compliance" with applicable law are in themselves responsibilities of huge scope. It defies belief that a director could be fined for *any* failure to ensure sound operations; necessarily, then, the Proposal fails to identify

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the directors' decisionmaking process [is] *measured by concepts of gross negligence* ... .") (emphasis in original).

[13] I am not aware of any judicial or administrative interpretations of corporate governance rules purporting to determine whether to impose liability upon directors because of a claimed failure to act on a "fully informed" basis.

when directors *will* be subject to fines or penalties, and the imprecision of the Proposal on this critical point again reflects a failure to serve the goals of predictability and fairness that are the essence of modern corporate governance law.

Under both Delaware law and the Model Act, for example, directors do not "ensure" corporate well-being or the integrity of corporate internal controls or accounting systems. To the contrary, they are subject to liability -- assuming (contrary to near universal practice) the absence of any exculpatory charter provision -- only for "sustained or systematic failure" to exercise their oversight responsibilities that amounts to or reflects bad faith.[14]

In the foregoing and other respects, the Proposal fails to satisfy a basic function of corporate governance law: "[d]irectors should be afforded reasonable predictability; they are entitled to know whether a contemplated course of action will result in personal liability for money damages."[15] By not providing reasonable predictability, the Proposal fails to satisfy the fundamental goal of fairness as well. If directors and their advisors cannot determine with confidence what level of conduct will

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[14] *In re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) ("only a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability."); MBCA §8.31(a)(2)(iv) (director liability for "sustained failure ... to devote attention to ongoing oversight of the business and affairs of the corporation ... .").

[15] MODEL BUS. CORP. ACT ANN. §2.02 Official Comment at 2-17.

satisfy legal requirements, it is inherently unfair to sanction those directors upon a *post hoc* judgment that their conduct failed to satisfy such requirements.

The Distinction Between Aspirational Standards of Director Conduct and Standards of Judicial Review of Director Action

In evaluating judicial decisions regarding director liability, it is important to note that courts applying state corporate governance law not uncommonly articulate ostensibly ambitious aspirational goals for director conduct, even as they set extremely narrow limits for such liability:

- In the previously discussed *Caremark* opinion in which the court limited director liability for oversight lapses to cases of "sustained or systematic failure ... establish[ing] ... lack of good faith," the court also observed that directors should "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility. Thus," the court continued, "I am of the view that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, ..." [16] Even qualified by the limiting insistence on

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[16] 698 A.2d at 970.

"good faith" conduct, this aspirational standard is superficially much more demanding than the "sustained and systematic failure" standard articulated in the same opinion for determining actual director liability.

- Similarly, and more recently, the Delaware Supreme Court addressed a complaint challenging extraordinary compensation decisions by the board of directors of The Walt Disney Co., resulting in severance payments to Michael Ovitz, Disney's former president, of upwards of $100 million for barely over a year of service. The Delaware Supreme Court was outspokenly skeptical whether the directors of Disney had acted appropriately, and it warned that:

> [T]he processes of the [ ] Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions.[17]

The court explained, however, the disparity between aspirations to "good corporate governance practices" and the demands of judicial review to determine director liability:

> [O]ur concerns about lavish executive compensation and our institutional aspirations that boards of directors of Delaware corporations live up to the highest standards of good corporate practices do not translate into a holding that these plaintiffs have set forth particularized facts [necessary to avoid dismissal

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[17] *Brehm v. Eisner,* 746 A.2d at 249.

of the complaint.][18]

Such aspirational standards and encouragement are a common feature of modern state corporate governance law. It is important, however, to recognize that such standards and encouragement do not determine director liability, for good reasons discussed below, grounded in efficiency as well as fairness.

Adverse Effect on Quality of Directors and their Managerial Efforts

The Proposal implicates serious concerns about efficiency. I do not pretend to know what, if any, past managerial failures on the part of management of either of the Enterprises might have elicited the Proposal, or why "current practices of the Enterprises and the supervisory standards of OFHEO", which the Proposal itself invokes,[19] should be considered insufficient to fulfill OFHEO's regulatory objectives. I do strongly believe, however, that imposing legal controls that include material threats of individual monetary liability as a tool to elicit more dedicated efforts by corporate directors is more likely in fact to produce the opposite result, and certainly is thoroughly

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[18] *Id.* The court subsequently reemphasized that "the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability." *Id.* at 256.

[19] 66 *Fed. Reg.* 47447.

contrary to the trend of modern corporate law.

There is no doubt that current and potential directors of the Enterprises will reasonably perceive the threat of such monetary liability, in the form of civil penalties or otherwise, for breach of the amorphous requirements of the Proposal. That threat poses even greater concern in light of the parallel aspect of the Proposal (§1710.31) that would establish that an Enterprise could not indemnify a director for such penalties in a proceeding initiated by OFHEO, even if the director's conduct was in good faith and believed to be in the best interests of the Enterprise.[20] Indeed, as I understand it, the Proposal would even preclude the acquisition by an Enterprise of insurance against OFHEO-imposed civil penalties for such circumstances. (Proposal §1710.31(b)(1)).

It is precisely such a threat of unindemnifiable, uninsurable personal liability for good faith errors or omissions that in the mid-1980's caused a dramatic decline in the willingness of qualified individuals to serve as directors of publicly held corporations.[21] OFHEO acknowledges the desirability of encouraging competent persons to serve as

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[20] State law would permit indemnification in such a case, again raising the possibility of conflict between state law rules of corporate governance and those of the Proposal. *E.g.*, 8 *Del. C.* §145(a); Va. Code Ann. §13.1-697(A).

[21] That decline was widely attributed to two arguably related phenomena: sudden unavailability or severe price increases of director and officer liability insurance, and the notorious (and anomalous) opinion of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 848 (Del. 1985) imposing monetary liability upon disinterested and independent directors for their approval of the sale of the corporation at a substantial premium to pre-existing market prices.

directors,[22] yet has put forward a Proposal that creates the very threat of unindemnifiable and uninsurable liability that once made it difficult to find such persons willing to serve.

Even apart from the foreseeable adverse effect of the Proposal on attracting and retaining highly qualified directors of the Enterprises, the liability threats implicit in the Proposal do not seem well calculated to elicit dedicated and effective efforts from the directors who do continue to serve as such. State law corporate governance systems have essentially abandoned *post hoc* monetary sanctions as a tool to elicit director care, and for good reasons. In an environment in which decisionmaking is inherently and deeply complex and not reducible to readily articulated and generally accepted standards, the imposition of *post hoc* liability on directors who act in good faith is likely to exhibit unfair hindsight bias ("a loss occurred, so someone must have misbehaved"). Such liability also promotes costly "overprecaution," reduces trust among directors and officers, impairs candid exchanges of information and criticism, and causes directors to adhere too long to failed strategies out of a desire to avoid admitting error suggesting liability.[23] Thus, the Proposal, with its patent threats of monetary liability for

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[22] 66 *Fed. Reg.* 47557 ("The Enterprises must be able to continue to attract and retain the highest caliber of board members and executive officers.").

[23] Professor Donald Langevoort has ably summarized these concerns in *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

disinterested director conduct, would reverse the progress of existing corporate governance schemes.[24]

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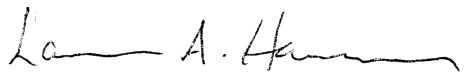
In sum, the Proposal in my estimation is likely to disserve the goals of predictability, fairness and efficiency that existing corporate governance systems have evolved to facilitate. An approach that allows the Enterprises to select and rely confidently upon a settled body of corporate governance law – whether a selected state law or the Model Business Corporation Act as amended – would be far more prudent and far more effective.

Respectfully,



Lawrence A. Hamermesh

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[24] A system that requires the agency to proceed by clear administrative directive (*i.e.*, a cease and desist order) before imposing penalties is fairer and likely to be more effective. In such a system, a director has reasonable notice before facing the prospect of a penalty.

Attachment

Professor Lawrence A. Hamermesh
Widener University School of Law, Wilmington, Delaware

Lawrence A. Hamermesh is Associate Professor of Law at Widener University School of Law in Wilmington, Delaware. Before joining the faculty at Widener in 1994, and while still in the private practice of law, Prof. Hamermesh served as a lecturer at the University of Pennsylvania Law School, teaching a seminar on mergers and acquisitions. Because of Prof. Hamermesh's experience with the subject of corporate governance, he has been retained by the Federal Home Loan Mortgage Corporation to review and provide comments on the Office of Federal Housing Enterprise Oversight's Corporate Governance Proposal (66 Fed. Reg. 47557 (Sept. 12, 2001)).

Prof. Hamermesh was admitted to the Delaware Bar in 1976, following graduation with a J.D. from Yale Law School. From 1976 through 1984, Prof. Hamermesh was an associate, and from 1985 until 1994 a partner, with the Wilmington, Delaware law firm of Morris, Nichols, Arsht & Tunnell. Prof. Hamermesh's practice with that firm concentrated heavily on two overlapping areas: transactional advice on issues of Delaware corporate law arising in connection with mergers and other transactions, and litigation involving issues of Delaware corporate law, including actions asserting breach of fiduciary duty in connection with merger and acquisition proposals. Among Prof. Hamermesh's appearances in such matters was his role in 1989 as principal Delaware counsel for Time Incorporated and its directors in connection with Time's merger with Warner Communications and its opposition to the unsolicited tender offer for Time by Paramount Communications. See *Paramount Communications Corp. v. Time Incorporated*, 571 A.2d 1140 (Del. 1989).

In 1995, Prof. Hamermesh was elected as a member of the Corporation Law Council of the Corporation Law Section of the Delaware State Bar Association (the "Council"). Prof. Hamermesh was the first, and remains the only, legal academic to serve as a member of the Council, and was elected as Vice Chair of the Council last year. The Council, consisting of approximately 18 members of the Delaware Bar, annually reviews proposals to amend and modernize the Delaware General Corporation Law ("DGCL"), and the Council's legislative proposals are widely respected and largely adopted into law by the Delaware General Assembly. This year, Prof. Hamermesh was also elected as a member of the Corporate Laws Committee of the Business Law Section of the American Bar Association, which supervises the widely-followed Model Business Corporation Act.

Prof. Hamermesh has published numerous articles, primarily on subjects of Delaware corporate law. In addition, he has been asked to speak on matters of Delaware corporate law in a variety of continuing legal education programs over the years. In 1999, Prof. Hamermesh was elected a member of the American Law Institute.