GEORGETOWN UNIVERSITY LAW CENTER

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December 13, 2001

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

Dear Mr. Pollard:

I am pleased to submit these comments on the Corporate Governance rules proposed by the Office of Federal Housing Enterprise Oversight, HUD (66 Fed. Reg. 47557 (Sept. 12, 2001)). I am a Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach both corporate law and securities regulation. These comments have been prepared at the request of the Federal Home Loan Mortgage Corporation. Their substance, however, reflects a view that I have long espoused about the risks of using liability rules to prompt corporate governance reforms.[1]

A. OFHEO's proposed regulations for corporate governance at Freddie Mac and Fannie Mae are excessive and would be counter-productive to the effort to encourage good governance

Proposed Subpart C, Section 1710.20, sets forth detailed standards for the conduct of board members, including specific duties of objectivity, due diligence and compliance with applicable law. It also demands that directors devote "sufficient" time to their responsibilities. The proposal states that this is based on the current standard set forth in state laws such as those based on the Model Business Corporation Act.

This is remarkably inaccurate. To be sure, many corporate law statutes contain standards calling for due care by directors. However, by both statute and case law, these standards are *not* made enforceable on their terms. As a result, these standards are often referred to as "aspirational" ones. Enforcement of director responsibilities is instead drawn from a very different norm: the business judgment principle. Absent self-dealing or bad faith, directors are not held liable for what in hindsight appears to be unreasonable conduct. One of the leading commentators on American corporate governance, Professor Melvin Eisenberg of the University of California, Berkeley, refers to this as a deliberate

[1] A more complete statement of my views is Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 Geo. L.J. 797 (April 2001). A copy of my curriculum vitae, with references to my other writings and experience, is attached.

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"acoustic separation" in corporate law.[2] Directors are encouraged to act at the higher standard of care, but not held liable unless their conduct falls below the floor set by the business judgment rule. This structure is explicitly written into the Model Act today, which has separate provisions for standards of conduct (section 8.30) and standards of liability (8.31).

The reasons for this choice are well-understood and uncontroversial in the corporate governance community. Directors will hesitate to serve, or be unduly cautious, in an environment of threatened liability. As discussed more below, they will be distracted from the task at which they are most crucial: overseeing and engaging in a dialog with management about the operations and risks faced by the enterprise. Just as important, diligence in a high-level business setting is hard for courts or agencies to assess fairly in hindsight, risking a bias toward blame.

The proposed regulations destroy this separation by making the aspirational standard an enforceable one, with the potential for civil penalties for nonobservance. While the proposals say they are borrowing from the Model Act, they ignore its crucial protective feature. Such a dramatic departure from prevailing law would send the wrong signal to qualified individuals considering board service at one of the regulated enterprises. The market for director talent today is a highly competitive one – the best directors are at a premium. A well-advised person would not choose a board position at one of the enterprises when he or she has attractive opportunities to serve elsewhere in a lower risk environment.

Proposed Section 1710.21 then substantially exacerbates this threat. Directors are charged with overseeing the safety and soundness of the enterprise, and their responsibilities are then extended into seven specific areas, including strategic oversight, financial reporting, legal compliance, etc.

I cannot imagine how directors could discharge these enforceable obligations prudently without undermining their essential function. The last twenty years have brought an immense body of research on what boards do, and how they add value to firms. What we have learned is that there are three basic functions: monitoring of management, offering external perspectives on risks and strategic choices facing the firm, and providing outreach to other important constituencies. They offer guidance and a moderate degree of supervision. Only in the rare case of crisis do they actually exert control over managerial decisions. Which of these functions is most important at any given time is unpredictable, and hence board members must have the discretion and flexibility to shift attention and emphasis, within the limits of the time available. The more defined and routine work they are made to do, the less effective they become because they lose that ability to improvise and attend deeply to what is most pressing.

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[2] See MELVIN EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 544-45 (8th ed. 2000); Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 Fordham L. Rev. 437 (1993).

To be sure, each of the seven defined matters is an appropriate subject for board attention and the aspirational and "best practices" standards of contemporary corporate governance call for such. But as noted above, this has not been coupled with a significant liability threat absent intentional misconduct, bad faith or deliberate disregard of responsibilities. Board members remain free to focus their attention on the matters they consider most pressing. Statutes and case law also specifically authorize reliance on other corporate officials to carry out the primary tasks of management and compliance, rather than insist that they oversee these things themselves.

Over the last decade in particular, the Securities and Exchange Commission – the agency with which I am most familiar – has been embarked on an effort to improve corporate governance standards as they relate to financial reporting, in response to perceptions of accounting abuse at some corporations. And some of its actions have been controversial. What is noteworthy, however, has been its restraint with respect to standards of director monitoring, and its careful effort not to destroy the separation between aspirational and liability rules. Properly, it has acted forcefully when directors have remained silent in the face of actual knowledge of impropriety. In contrast, its efforts to prompt better monitoring have been extremely cautious. The recently adopted audit committee rules are a good example. Independent audit committees have long been required by the major stock exchanges,[3] and the SEC has encouraged the exchanges and the accounting profession to create a greater role for this committee. In 1999, a Blue Ribbon Committee proposal to the Commission suggested that audit committee members, among other things, be required to issue a report stating that they had reviewed the financial statements and discussed reporting judgments with both management and auditors, and after so doing, had concluded that the financial reports materially conform to generally accepted accounting principles. The SEC, however, rejected this as creating too big a workload and liability threat and moderated the requirement so that the committee today merely states whether it recommends that the financial statements be filed with the SEC.[4]

Thus, even in the face of a demonstrable problem – financial misreporting and earnings management by some issuers – the SEC chose a posture of restraint with respect to enforceable monitoring obligations, lest the ability to attract good audit committee directors be compromised. What is so noteworthy here is how restrained even the *recommended* requirement was, much less the one finally adopted, compared to the specifically enforceable OFHEO proposal that all directors[5] carefully oversee the adequacy of reporting and communication both to investors and federal regulators.

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[3] The New York Stock Exchange and Nasdaq have also exercised considerable restraint on matters of corporate governance. Though they require audit committees, for example, the exchanges do not impose any conduct rules with respect to them, much less impose liability standards. In the view of the exchanges, these are matters best left largely to state law.

[4] See *Audit Committee Disclosure*, Exch. Act Rel. 41987, Oct. 7, 1999.

[5] A fair reading of the proposals calls into doubt whether the full board could safely rely on a committee to discharge any particular task. Proposed Section 1710.21 makes each of the seven oversight areas a board obligation, and proposed Section 1710.11 says that the use of committees will not relieve board members of any responsibility established by federal rules or regulations.

Moreover, the SEC effort was focused only on one crucial subject, not the seven proposed here.

I do not mean for these concerns to sound defensive or protectionist. There is a superficial appeal to the idea that if good governance is important, the law should require it and police for shortcomings. But it is important to see that in the U.S. and abroad, corporate governance has improved dramatically in the last decade without any appreciable step-up in the legal risk faced by directors. Professor Eisenberg said recently that "the common experience of informed observers is that the level of directorial care has risen significantly in the last ten years or so. . . . What has caused this shift to a greater level of care? Pretty clearly, *not* an increased threat of liability."[6] Rather, director norms have evolved voluntarily with respect to the monitoring and, when necessary, removal of senior executives, and for constructive involvement on matters such as auditing and financial reporting, legal compliance, and business strategy.[7] The reason is simple. Sensible director monitoring adds value to the firm, and thus the capital markets demand it.[8]

Indeed, there is a strong consensus in the corporate governance community today that the main job for law with respect to corporate governance practices is to assure that they are fully disclosed. In this setting, penalties imposed on directors for lack of diligence are both unnecessary and chilling. Put another way, were the well-established legal regime associated with director diligence perceived as overly lax, we would hear loud calls for reform by investors, particularly institutional ones. But today, no *investor* group is pushing seriously to dismantle the business judgment rule or make high-level director monitoring a legal requirement. To my knowledge, the only occasional push in that direction comes from the plaintiff's bar.

B. The proposed indemnification rules are a further step in creating undue risk for directors

The proposed indemnification rules compound the unnecessary threat created by the governance proposals. The rule that directors may not be reimbursed for legal fees or other expenses associated with an administrative proceeding that results, through settlement or judgment, in a cease and desist order or a civil penalty is itself harsh and out of step with well-accepted corporate law principles. The rules both in Delaware and under the Model Act permit broad indemnification rights both for amounts paid in settlement or judgment (except in derivative suits) and – without exception – for reasonable legal expenses, so long as the director is found to have acted in good faith and in a manner reasonably believed to have been in the best interest of the corporation, without regard to whether the director prevails on the merits. Though a technical-

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[6] See Eisenberg, *Corporate Law and Social Norms*, 99 Colum. L. Rev. 1253, 1266-69 (1999)(emphasis added).

[7] See, e.g., Bhagat & Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921 (1999).

[8] To be sure, federally supervised financial entities, such as the enterprises, must be operated in a safe and sound manner, as well as deliver a return to investors. But there is no reasons to suspect that there is a tension between these goals that requires a step-up in the liability threat to their directors.

sounding issue, indemnification is an important piece of corporate law's effort to encourage the free exercise of business judgment by directors. Chief Justice Norman Veasey of the Delaware Supreme Court calls it one leg of the "three-legged stool" for promoting director confidence.[9]

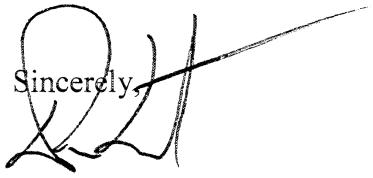
I understand that the indemnification rules for FDIC-insured financial institutions are similar to the proposals here, and hence depart to the same degree from what general corporate law provides. Obviously, I cannot pass judgment on the desirability of these banking rules. However, I expect that they were the product of a unique crisis in the kinds of risks taken in the savings and loan and banking industries during the 1980's. Absent a comparable crisis, I cannot imagine why the well-agreed-upon norm on indemnification reflected in corporate law today would be abandoned.

The departure from the norm is striking enough. When combined with the risk created by the OFHEO proposal that an administrative proceeding alleging director shortcomings, without regard to the directors' good faith, in any of the enumerated areas could result in a form of remedial order for which no indemnification is permitted, their effect would be particularly severe. This combination places directors in the uncomfortable position of having to litigate fully any charges against them that they believe are unfair or inappropriate, rather than settle, in order to retain a right to indemnification – while in so doing spending that much more in legal fees, with the consequent risk of major out-of-pocket loss should there be an adverse finding. Again, it is hard to imagine talented people with many opportunities for director service choosing to join the board of one of the regulated enterprises under these conditions.

C. Conclusion

For all the foregoing reasons, I would urge that OFHEO not adopt these or any similar corporate governance rules. With the minimal federal overlay of SEC regulation, state law today provides a well-balanced legal regime to encourage good corporate governance at the regulated enterprises. The enterprises should be allowed to continue to rely on state corporate governance law as they have in the past. Adoption of the proposed rules would do no additional good, and threaten a fair amount of harm.

Sincerely,



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[9] Veasey, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 Bus. Law. 399 (1987).

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Birthdate: February 20, 1951
Family Status: Married (Joni J. Langevoort), 1 daughter and 1 son

Teaching Experience:

July 1999 – present — Professor of Law , *Georgetown University Law Center*

Courses: Securities Regulation, Corporations, Securities Fraud Seminar

August 1981 – June 1999 — *Vanderbilt Law School*

Lee S. and Charles A. Speir Professor of Law (1990 - 1999)
Professor (1988 - 1990)
Associate Professor (1985-88)
Associate Dean (1984-86)
Assistant Professor (1981-85)

Courses: Contracts, Securities Regulation, Regulation of Financial Institutions, Corporations, Selected Issues in Corporate Litigation
Contracts Theory Seminar

Paul J. Hartman Award for Excellence in Teaching (1983, 1990, 1998 and 1999)

August 1998 - December 1998 — Visiting Professor of Law
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August 1987 - June 1988	Visiting Professor of Law, *University of Michigan* (fall semester), *Harvard Law School* (spring semester)
August 1980 - May 1981	Lecturer, *Washington College of Law, American University* (Business Associations I&II)

Other Employment:

December 1978 - July 1981	Special Counsel, Office of the General Counsel, United States Securities & Exchange Commission, Washington, D.C.
August 1976 - December 1978	Associate, Wilmer Cutler & Pickering, Washington, D.C.

Educational Experience:

J.D., Harvard Law School, June 1976. Editor, *Harvard Law Review* (vols. 88-89) (Senior Editor, vol. 89)

B.A., University of Virginia, June 1973. Concentration in religion and social philosophy. Awarded highest honors. Chairman, Curriculum Reform Committee. Phi Beta Kappa. Raven Society. Echols Scholar.

Publications:

Books:

INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION (West Group (formerly Clark Boardman Callahan) 1991, with annual supplementation 1992-present)

INSIDER TRADING REGULATION (Clark Boardman Co., 6 eds.: 1985-91)

SECURITIES REGULATION: CASES AND MATERIALS (with J. Cox and R. Hillman) (1st ed., Little Brown & Co. 1991, with annual supplements; 2d and 3d eds., Aspen Law and Business., 1997 and 2001, with annual supplements)

Articles:

The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability, GEORGETOWN LAW JOURNAL, vol. 89, p. 797 (2001)

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What Was Kaye Scholer Thinking?, LAW AND SOCIAL INQUIRY, vol. 23, p. 297 (1998)(commentary on William Simon's *The Kaye Scholer Affair: The Lawyer 's Duty of Candor and the Bar's Temptations of Evasion and Apology*)

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Symposium Introductory Essay -- Of Forests and Trees: The Jurisprudence of Rule 10b-5, ALBANY LAW REVIEW, vol. 39, p. 629 (1989)

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Interpreting the McFadden Act: The Economics and Politics of Shared ATM's and Discount Brokerage Services, THE BUSINESS LAWYER, vol. 41, p. 1265 (1986).

The Education of a Securities Lawyer (book review of L. Loss, *Fundamentals of Securities Regulation*), NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 80, p. 259 (1985).

Professional Memberships and Activities:

Member, American Law Institute

Member of the SEC Advisory Committee on Market Data (2000-2001)

Member of the Legal Advisory Committee, New York Stock Exchange (1996-99)

Member of the Legal Advisory Board, National Association of Securities Dealers (NASD) (1988-93)

Editor-in-chief, SECURITIES LAW REVIEW (West Group) (since 1984).

Member, American Bar Association, Section on Business Law, Committee on the Federal Regulation of Securities

Chair, American Bar Association, Section on Business Law, Ad Hoc Committee on the Business Lawyer as a Problem Solver (1998-2000)

Member of the Bar: District of Columbia, United States Court of Appeals for the District of Columbia and Sixth Circuits, and United States Supreme Court

Public Arbitrator, National Association of Securities Dealers and American Arbitration Association

Chair, Section on Business Associations, American Association of Law Schools (1993)

Chair, Section on Financial Institutions and Consumer Financial Services, American Association of Law Schools (1991)

Chair, Section on Securities Regulation, American Association of Law Schools (2001)

Member of the Tennessee Corporation Law Revision Committee (1985-86)

Member of the Editorial Advisory Board, INSIGHTS:THE CORPORATE & SECURITIES LAW ADVISOR (Prentice Hall)

Lecturer at various professional meetings and institutes, including: the Southwestern Legal Foundation's Course on Securities Regulation (Dallas) each year since 1986 (program Chairman since 1989); the University of California's Institute on Securities Regulation (San Diego, January 1987); the International Conference on Insider Trading, University of Rome (Sapienza) (October 1989); the International Symposium on Takeover Regulation sponsored by the University of Ghent in Brussels, Belgium (May 1991); various programs of the Sections on Business Associations and Financial Institutions at AALS annual meetings; the Conference on Securities Litigation Reform, Tuscon, Arizona (December 1995), the Catholic University Symposium on Corporate Morality and Disclosure (April 1998), and the Harvard Medical School/Massachusetts Mental Health Center Symposium on Investor Psychology (June 1998)

Congressional testimony on securites law matters: U.S. Senate Subcommittee on Securities (Committee on Banking, Housing and Urban Affairs) on S. 1380 (December 1987) and on the impact of the Supreme Court's *Central Bank of Denver* decision (May 1994); U.S. House of Representatives Subcommittee on Telecommunications and Finance (Committee on Energy and Commerce) on H.R.

975 (July 1989) and on the general question of class action litigation reform in securities cases (August 1994)

Informal consultant to the White House Office of Counsel to the President on the issue of securities litigation reform, July-December 1995

Annual endowed lecture on securities regulation, entitled "The SEC as a Bureaucracy," Washington & Lee University Law School, March 1990

Graduate Colloquium lecture at Fordham University School of Law, entitled "Rule 10b-5 as an Adaptive Organism," November 1992

Eleventh Francis X. Pillegi Lecture at Widener University School of Law, October 1995, entitled "Words from on High About Rule 10b-5"

Seventh Abraham Pomerantz Lecture at Brooklyn Law School, April 1997, entitled "Beliefs, Biases and Organizational Behavior: Challenges for the Corporate-Securities Lawyer"