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A Commentary on McDonnell, Ahdieh, Hamermesh, and Johnson's Views on Federal Corporation Law and the *AIG* Kerfuffle

IN THIS ESSAY, I WILL COMMENT ON BRETT McDONNELL's paper entitled "Recent Skirmishes in the Battle Over Corporate Voting and Governance";¹ a paper by Robert Ahdieh called "Intersystemic Governance in Corporate Law: The Dialectical Regulation of Rule 14a-8";² a paper by Lawrence Hamermesh called "The Policy Foundations of Delaware Corporate Law";³ and a paper by Jennifer Johnson called "What's Good for the Goose? A Critical Essay on 'Best Practices' for Private Firms."⁴ Then I will add a few comments of my own about the Second Circuit's recent decision in *American Federation of State, County & Municipal Employees v. American International Group*.⁵

Brett McDonnell's thought-provoking paper addresses the question of whether our mixed federal system achieves a good trade-off between producing high-quality law versus achieving a desirable balance between management and non-management interest groups.⁶ McDonnell uses the response to the Enron-esque scandals of the early 2000s as a jumping-off point.⁷ The question is whether our mixed system worked better than a purely state or national system would have worked.

I was particularly struck by McDonnell's observation that a national system might have worked better than our mixed system in addressing the corporate scandals.⁸ But, as he argues, the problem is rather than intervening too much, Congress

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1. Brett H. McDonnell, *Recent Skirmishes in the Battle Over Corporate Voting and Governance*, 2 J. BUS. & TECH. L. 349 (2007).

2. Robert Ahdieh, *Intersystemic Governance in Corporate Law: The Dialectical Regulation of Rule 14a-8*, 2 J. BUS. & TECH. L. 165 (2007).

3. Lawrence Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006).

4. Jennifer Johnson, *What's Good for the Goose? A Critical Essay on "Best Practices" for Private Firms*, 2 J. BUS. & TECH. L. 251 (2007).

5. *Am. Fed'n. of State, County & Mun. Employees v. Am. Int'l. Group (AIG)*, 462 F.3d 121 (2d Cir. 2006).

6. McDonnell, *supra* note 1, at 350.

7. *Id.*

8. *Id.* at 355–58.

and other national regulators are often prone to intervene too little.⁹ McDonnell correctly points out that this inaction is largely due to the fact that managers are better financed and organized than non-management groups, such as shareholders.¹⁰

McDonnell uses this observation to suggest an approach that courts can use to analyze certain Securities and Exchange Commission (SEC) regulations, including the proxy access rule.¹¹ According to McDonnell, when all things are equal, the Court should interpret federal rules against the interests of managers.¹² Under such an approach, if the Court errs, managers will be able to reverse the law either through appeal, administrative remedies, or legislative recourse.¹³ After all, management is well organized.

Even though this canon of construction has a certain amount of intuitive appeal, I am not sure that courts would actually explicitly adopt it. Nevertheless, it certainly deserves additional thought. When we read papers, sometimes we see the germination of a big idea that we hope that will lead to the next paper. I would enjoy seeing McDonnell develop this idea more. Perhaps McDonnell could compare the advantages of his suggested interpretive approach to the judiciary's existing approaches to interpreting SEC rules, such as judicial deference towards an agency's own interpretation of its rules.¹⁴ If McDonnell did this, perhaps he would be able to demonstrate that his approach is superior to existing approaches.

Like Brett McDonnell, Robert Ahdieh is interested in our mixed system of corporate law.¹⁵ I enjoyed Ahdieh's argument that federal corporate law is helpful because it forces the courts to engage significant issues and promotes innovation.¹⁶ I think that Ahdieh offers a promising framework for thinking about the interaction between state and federal law, especially in the shareholder proposal arena. Ahdieh's framework is promising because it is difficult, if not impossible, to determine whether the substance of a bylaw should be regulated by state law or federal laws.¹⁷

Ahdieh hopes that this type of mixed corporate governance or this systemic regulation would lead to additional interaction between the federal and state lawmaking bodies.¹⁸ In other words, Ahdieh has suggested that the SEC would be able to

9. *Id.* at 362.

10. *Id.*

11. *Id.* at 365.

12. *Id.*

13. *Id.*

14. See, e.g., *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (holding that an agency's interpretation of its own regulation is entitled to deference when the regulation is ambiguous); *Chevron, U.S.A., Inc. v. Nat'l Res. Def. Council, Inc.*, 467 U.S. 837, 843–44 (1984) (holding that courts must defer to reasonable interpretations of federal statutes by the relevant administrative agencies).

15. See Ahdieh, *supra* note 2, at 166.

16. *Id.* at 181–82.

17. *Id.* at 171–72.

18. *Id.* at 183.

ask the Delaware legislature or Delaware courts for their opinions on certain important issues of state law.¹⁹ But that might be asking too much, given what we know about how Delaware policymaking works.²⁰

Lawrence Hamermesh's paper is extremely valuable because it offers a unique insight into the formation of Delaware corporate law. According to the paper, fending off federal incursion is only significant at the margins in Delaware.²¹ However, the conventional wisdom is that federal law is actually extremely significant and acts as a limitation on Delaware law.²² Thus, Hamermesh offers a provocative argument. Hamermesh is able to make such an argument because of his unique position in the Delaware corporate law community.²³ Hamermesh's unique position also allows us to give serious attention to his identification of, and observations on, the heuristics used by Delaware corporate law policy makers.

Perhaps because of these powerful heuristics, Hamermesh believes that Delaware will be an interested but largely inactive bystander to future federal efforts to reform corporate governance.²⁴ Based on his persuasive articulation of the policy foundations of Delaware corporate law, this appears to be a solid prediction, at least in most cases. But I wonder if the recent increase in shareholder activism²⁵ will force Delaware corporate law policy makers, and perhaps even the courts, to put aside their foundations, principles or heuristics and actually become more active themselves, particularly regarding the proxy access issue. After all, the proxy access issue puts Delaware's bylaw rule²⁶ front and center.²⁷

If shareholders ultimately gain access to the proxy under federal law, it would seem that Delaware might finally have to face the question, as Hamermesh asserts, that they have been successfully ducking for years: the extent to which a bylaw can limit the authority of the board.²⁸ At the very least, Delaware would have to con-

19. *Id.* at 175.

20. Lawrence Hamermesh, *How We Make Law in Delaware, and What to Expect From Us in the Future*, 2 J. BUS. & TECH. L. 409, 409–10 (2007).

21. Hamermesh, *supra* note 3, at 1771.

22. See, e.g., Tamar Frankel, *The Delaware Business Trust Act: Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325, 343 (2001); Hilary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 459–60 (2004); Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 178 (2004).

23. Professor Hamermesh is a member of the Corporation Law Council of the Corporation Law Section of the Delaware State Bar Association, which is responsible for the annual review and modernization of the Delaware General Corporation Law. In addition, Professor Hamermesh is a member of the American Law Institute and the Ruby R. Vale Professor of Corporate and Business Law at Widener University School of Law's Delaware campus.

24. Hamermesh, *supra* note 3, at 1774.

25. See, e.g., G. Jeffrey MacDonald, *A Record Year for Shareholder Activism*, CHRISTIAN SCI. MONITOR, June 28, 2004, at 14; Shawn Tully, *Proxy Muses*, FORTUNE, Dec. 25, 2006, at 159; Jan Frel, *'Tis the Season for Shareholder Activism*, CORPWATCH, May 4, 2005, <http://www.corpwatch.org/article.php?id=12195>.

26. DEL. CODE ANN. tit. 8, § 109 (1974).

27. See, e.g., Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1772–74 (2006).

28. Hamermesh, *supra* note 3, at 1772–73.

sider whether directors have the power to undo shareholder-adopted bylaws that grant access to the proxy. The Delaware legislature has already taken some action in this area. Last summer the Delaware legislature adopted amendments to the General Corporation Law. These amendments prohibit boards from undoing shareholder-adopted bylaws that require majority voting for directors.²⁹ I look forward to hearing Hamermesh's thoughts on this issue in the future.

All of the other papers address important issues relating to federal regulatory initiatives that were intended to federalize some aspects of state corporate law.³⁰ Jennifer Johnson's excellent paper demonstrates, however, that the federal government can impact state corporate law without intending to do so.³¹ This idea of unintended federalization of corporate law is fascinating.

Johnson observes that some private companies have voluntarily adopted some aspects of federal corporate law, specifically, the use of independent directors in an attempt to comply with the "best practices" in corporate governance.³² The corporations hope that the adoption of "best practices" will serve as a liability shield. Johnson persuasively demonstrates that private companies could be harmed by blindly adopting corporate governance requirements that were aimed at public companies.³³ In particular, I appreciated her discussion of the relative importance of the board's monitoring and advisory roles in public and private companies.³⁴

After reading Johnson's paper, I wondered what private companies can do these days. It seems as if private companies are caught between a rock and a hard place. If private companies fail to make their boards more independent, they risk being sued for failing to follow "best practices."³⁵ If private companies make their boards more independent, no matter how ill-advised, they risk losing the benefits of non-independent director's advice.³⁶

Johnson does an excellent job of pointing out these problems, but she does not offer a solution to the problem. This is not a criticism of the paper because Johnson did not intend to offer a solution. I am simply curious about Johnson's solution. Does the answer lay in our old friend the business judgment rule? In other words, if a private company's board carefully considers and then rejects adding additional independent directors to their board, is that decision protected by the business judgment rule? Is the board able to exchange one liability shield for another or does

29. DEL. CODE ANN. tit. 8, § 216 (Supp. 2006) (amending the statute, effective as of Aug. 1, 2006, to read that "[a] bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors").

30. See generally Ahdieh, *supra* note 2; Hamermesh, *supra* note 3; McDonnell, *supra* note 1.

31. Johnson, *supra* note 4, at 264–66.

32. *Id.* at 264.

33. *Id.* at 268.

34. *Id.* at 269–70.

35. *Id.* at 271.

36. *Id.*

Johnson have something else in mind? I would be very interested in the answers to these questions.

This conference is timely because last month, the Second Circuit, in *American Federation of State, County & Municipal Employees v. American International Group (AIG)*,³⁷ directed a corporation to include a shareholder proposal that would require the company to include shareholder-nominated directors on the company's proxy.³⁸ Elsewhere, others have suggested that the court favored shareholder empowerment even though the Second Circuit expressly stated that they were taking no side in the policy debate.³⁹ That may be true, and certainly that is the result of the case, but I read the case in a different way. To me, the opinion is more anti-SEC than pro-shareholder. The court was clearly troubled by the SEC's failure to explain the change in its interpretation of the election exclusion.⁴⁰ In fact, the court appeared to be downright annoyed that the SEC would not even concede that there had been a change.⁴¹ The court said the SEC is able to change its interpretations whenever they want, but they just have to explain it.⁴² The court invited the SEC to do so, and the SEC took them up on the invitation, scheduling a meeting that will take place next week.⁴³

The Second Circuit takes the SEC to task several times on both the SEC's rule interpreting process and substantive rulemaking. In fact, the court expressly states that the court is not going to defer to an SEC rule.⁴⁴ The court was tough on the SEC's process by requiring the SEC to explain its change in interpretation.⁴⁵ As we all know, that is not the usual practice with no-action letters.⁴⁶ In the past, the SEC has made huge changes in policy through its no-action letters with no explanation.⁴⁷ So in that sense, the court was tough on the SEC's process.

The court was a little tough on the SEC substantively as well. The SEC has valid concerns that shareholder proposals, like the one in *AIG*, would lead to uninformed voting by shareholders.⁴⁸ As the SEC explained in its amicus letter brief, if

37. 462 F.3d 121 (2d Cir. 2006).

38. *Id.* at 123.

39. See, e.g., *AIG Shareholders Win Ruling on 'Holy Grail' of Proxy Access*: AFSCME Employee Pension Plan v. AIG Inc., 22 ANDREWS CORP. OFFICERS AND DIR. LIAB. LITIG. REP. No. 6, at 5 (Sept. 18, 2006); Richard P. Swanson & Darlene F. Routh, *Shareholders Ready for Battle*, 236 N.Y.L.J. (Nov. 20, 2006) col. 1.

40. *AIG*, 462 F.3d at 129.

41. *Id.*

42. *Id.*

43. Press Release, U.S. Sec. & Exch. Comm'n., Commission Calendars Proposed Amendment to Rule 14a-8 Governing Director Nominations by Shareholders (Sept. 7, 2006), available at <http://www.sec.gov/news/press/2006/2006-150.htm>.

44. *AIG*, 462 F.3d at 129.

45. *Id.*

46. See, e.g., *N.Y. City Employees' Ret. Sys. v. SEC*, 45 F.3d 7, 12 (2d Cir. 1995) (citing Securities Exchange Act Rule 14a-8(d)(3)).

47. See, e.g., Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 948-67 (1998).

48. *AIG*, 462 F.3d at 130 n.9.

proposals like AIG's are adopted, shareholders would be permitted to nominate directors without providing important information that is normally required in contested elections, such as the interests of each participant in the election.⁴⁹

In any case, I wonder if the controversy over the election exclusion will soon be rendered moot by other pending regulatory initiatives. As many of you know, last December the SEC proposed rules that, if adopted, would permit the furnishing of proxy materials on websites after sufficient notice.⁵⁰ If adopted, these rules would reduce the importance of shareholder proposals because the cost of a proxy contest would be significantly reduced.⁵¹ In short, I wonder whether the AIG kerfuffle might actually turn out to be much ado about nothing that merely shifts the focus to a different area of federalism.

49. See *id.*; Response to Inquiry of the Court at 12, *Am. Fed. of State, County & Mun. Employees, Employees Pension Plan v. Am. Int'l Group*, No. 05-2825-cv (2d Cir. Mar. 24, 2006).

50. Press Release, U.S. Sec. and Exch. Comm'n, SEC Votes to Propose Rule to Provide Investors with Internet Availability of Proxy Materials (Nov. 29, 2005), available at <http://www.sec.gov/news/press/2005-166.htm>.

51. *Id.*