

THE SEC AND COURT-APPOINTED DIRECTORS: TIME TO TAILOR THE DIRECTOR TO FIT THE SUIT

The Securities and Exchange Commission (SEC) has often requested ancillary relief¹ beyond that expressly authorized by statute to address allegations of corporate misconduct. During the latter half of the 1970s, courts approved without analytical inquiry settlements that required the appointment of directors² not previously affiliated with the corporate defendant. This intervention into corporate structure, though not ordered unless consented to by the defendant, is based only on the broad equitable powers of a federal district court to issue injunctive relief for violations of the federal securities laws and to effectuate the legislative objective behind those laws.³ The SEC has, however, expanded the use of this injunctive relief and thereby detached the di-

1. The concept of ancillary relief, developed soon after initial passage of the securities laws, served to implement the injunctive relief authorized by statute. *See, e.g.,* *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 288 (1940) (power to enforce implies power to utilize available procedures or actions to make recovery effective); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 802 (E.D. Pa. 1947) ("existence of a remedy is implicit under general principles of the law"); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712, 714 (D. Del. 1943) (receiver appointed by court to implement injunction). *See* notes 13-30 *infra* and accompanying text. Other ancillary relief besides appointment of directors and receivers includes rescission of transactions, prohibitions against future transactions, share voting restrictions, appointment of advisory professionals, and disgorgement of monies improperly acquired. For an in-depth discussion of the various types of ancillary relief, see Mathews, *SEC Civil Injunctive Actions—II*, 5 REV. SEC. REG. 949 (1972).

2. One of the initial cases employing court-appointed directors was *SEC v. VTR, Inc.* The court, in lieu of appointing the requested receiver, directed the election of four designated independent directors to sit on the five person board. These individuals were to determine the exact amount of funds misappropriated by management as well as supervise the filing of proper annual reports and proxy statements. 32 SEC ANN. REP. 116-17 (1966). The arguments of defense counsel not only prevailed but also proved to be an accurate assessment of what could be accomplished by court appointment of new directors in response to management fraud. In contrast to the usual results that accompany the assignment of a receiver, the corporation continued its business and made approximately \$1.4 million in restitution. *See* Mathews, *Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions*, 31 BUS. LAW. 1323, 1326 (Special Issue 1976).

Ironically, in *VTR* the SEC argued against a remedy that it would use extensively in the 1970s. For articles discussing the court appointment of directors in SEC injunctive actions, see Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); Malley, *Far-Reaching Equitable Remedies Under the Securities Acts and The Growth of Federal Corporate Law*, 17 WM. & MARY L. REV. 47 (1975); Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637 (1975); Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L. J. 737 (1976) [hereinafter cited as *Ancillary Relief*]; Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975) [hereinafter cited as *Equitable Remedies*].

3. *See* notes 13-30 *infra* and accompanying text.

rector appointment remedy from its legal underpinnings. In addition, the Commission has employed director appointments as a means to pursue policies of corporate governance rather than merely to remedy alleged violations of law.⁴

This Note will trace the development of court-appointed directors in SEC injunctive actions and analyze both the legal justifications underlying the remedy and the practical aspects of this type of consent decree. This Note will then explain and comment upon the relationship between the appointment of directors to redress alleged wrongdoing and the Commission's influence on corporate governance as a means for reform. Finally, this Note will suggest that the SEC modify use of director appointments to return the remedy to its legal foundation and will point to recent developments in the Commission's approach that enhance the usefulness of the remedy.

I. THE DEVELOPMENT OF COURT-APPOINTED DIRECTORS AS ANCILLARY TO INJUNCTIVE RELIEF

The SEC is responsible for implementing and enforcing laws that promote integrity in the trading and distribution of securities and that protect the public from potential abuse.⁵ The Securities Act of 1933 and the Securities Exchange Act of 1934 empower the Commission to bring suits for infractions in the federal district courts⁶ and to seek civil injunctions against "any person . . . engaged or about to engage in any acts or practices which constitute or will constitute a violation" of these laws.⁷ No provision in any of the federal securities laws, however, ex-

4. Due to the nature of the consent decree process, the SEC has been able to secure settlement terms arguably beyond the reach of the ancillary relief contemplated by the courts. See notes 31-37 & 100-02 *infra* and accompanying text. For an article critical of SEC use of its civil injunctive remedy, see Mathews, *The SEC and Civil Injunctions: It's Time to Give the Commission an Administrative Cease and Desist Remedy*, 6 SEC. REG. L.J. 345 (1979).

5. See Sommer, *The Impact of the SEC on Corporate Governance*, LAW & CONTEMP. PROB., Summer 1977, at 115, 118.

6. Securities Act of 1933, § 22(a), 15 U.S.C. § 77v(a) (1976); Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1976).

7. The 1933 and 1934 Acts contain nearly identical language authorizing SEC civil injunctive actions. See Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1976); Securities Exchange Act of 1934, § 21(e), 15 U.S.C. § 78u(e) (1976). Section 18(f) of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79n(f) (1976), has a similar provision, and the Trust Indenture Act of 1939, § 322(a), 15 U.S.C. § 77uuu(a) (1976), adopts the enforcement provision of the 1933 Act. Both the Investment Advisor and Investment Company Acts authorize the Commission to enforce compliance by lawsuit and to enjoin illegal acts or practices. Investment Advisors Act of 1940,

pressly authorizes court appointment of directors.⁸ Changes in the composition of corporate boards occur instead through permanent injunctions negotiated by the Commission, consented to by the defendant, and entered by the court.

The settlements stipulate that the defendant neither admits nor denies the SEC's allegations. The flexibility of the approach permits creative formulation of relief that the parties can tailor to address a particular situation.⁹ Use of the consent decree process encounters little judicial resistance¹⁰ and is attractive to both the Commission and the defendant corporations.¹¹ Decrees that require court-appointed outside directors are subject to criticism, however, because they intrude into an area traditionally regulated by state law and infringe upon the principle of shareholder democracy.¹²

A. *Legal Underpinnings of the Director Appointment Remedy*

Certain sections of the Securities Acts authorize the Commission to seek court orders permanently enjoining defendants from violating the securities laws.¹³ Because standards governing the issuance of statutory injunctions are broad, federal courts are guided more by legislative objectives and public interest¹⁴ than by the showing of irreparable

§ 209(e), 15 U.S.C. § 80-9(e) (1976); Investment Company Act of 1940, § 42(e), 15 U.S.C. § 80a-41(e) (1976).

8. See Farrand, *supra* note 2, at 1781; Malley, *supra* note 2, at 58; Wolfson, *From the Boardroom—Needed: statutory reform to improve consent decree process*, HARV. BUS. REV., Mar./Apr. 1979, at 19; Comment, *Ancillary Relief*, *supra* note 2, at 740; Comment, *Equitable Remedies*, *supra* note 2, at 1189.

9. See Sommer, *supra* note 5, at 133; Sporkin, *SEC Developments in Litigation and the Molding of Remedies*, 29 BUS. LAW. 121, 122 (Special Issue, 1974); Comment, *Equitable Remedies*, *supra* note 2, at 1192.

10. Courts are reluctant to interfere with a settlement agreed to by the parties. See notes 101-16 *infra* and accompanying text. When requests for this relief have been presented in cases litigated on the merits, the outcome has been different. See notes 117-24 *infra* and accompanying text.

11. See Merrifield, *Investigations by the Securities and Exchange Commission*, 32 BUS. LAW. 1583, 1627 n.160 (1977); Wolfson, *supra* note 8, at 19; Comment, *Equitable Remedies*, *supra* note 2, at 1192.

12. See notes 126-40 *infra* and accompanying text.

13. Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1976); Securities Exchange Act of 1934, § 21(e), 15 U.S.C. § 78u(e) (1976).

14. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944).

harm and the other specific elements required in private litigation.¹⁵ Although injunctive relief is no longer properly characterized as a "mild prophylactic,"¹⁶ the SEC's perception that the relief is inadequate has resulted in expanded remedial orders, including the court appointment of directors.¹⁷

Congress granted the federal courts jurisdiction to hear "all suits in equity . . . to enforce any liability or duty created by [the Securities Acts]."¹⁸ Once a court's equity power is invoked, it may fashion appropriate relief to remedy the misconduct and prevent future violations.¹⁹ Courts, when issuing an injunction, have the power to order a broad range of measures designed to effectuate the congressional scheme.²⁰

15. SEC v. Management Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975); SEC v. Tax Serv., Inc., 357 F.2d 143, 145 (4th Cir. 1966); Brandford v. SEC, 278 F.2d 566, 567 (9th Cir. 1960).

16. This label was used by both the Supreme Court and the dissenting judges of the Second Circuit in SEC v. Capital Gains Research Bureau, 375 U.S. 180, 193 (1963), *rev'g*, 306 F.2d 606 (2d Cir. 1962) (en banc). The Supreme Court in Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979), held that SEC injunctions could have collateral estoppel effect in subsequent private actions. *Id.* at 332-33. See Mathews, *supra* note 4, at 352. See generally Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 CATH. U.L. REV. 215, 276-77 (1980).

17. See Sommer, *supra* note 5, at 128-31; Sporkin, *supra* note 9, at 122-23. See also notes 31-37 *infra* and accompanying text.

18. Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1976). See also Securities Act of 1933, § 22(a), 15 U.S.C. § 77v(a) (1976).

19. See, e.g., Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386, 390-91 (1970); J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964); SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir. 1980); Handler v. SEC, 610 F.2d 656, 659 (9th Cir. 1979); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 390-91 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162, 182 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). See also 1 J. POMEROY, EQUITY JURISPRUDENCE §§ 114-15, 171(1), 181, 231, 236(a), 239(c) (5th ed. 1941); Farrand, *supra* note 2, at 1781; Sporkin, *supra* note 9, at 122-23; Treadway, *supra* note 2, at 639; Comment, *Ancillary Relief*, *supra* note 2, at 741; Comment, *Equitable Remedies*, *supra* note 2, at 1189.

20. See, e.g., Mills v. Electric Auto-lite Co., 396 U.S. 375, 386-89 (1970); J.I. Case Co. v. Borak, 377 U.S. 426, 433-35 (1964); Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 291-92 (1960) (quoting Clark v. Smith, 38 U.S. (13 Pet.) 195, 203 (1839)); Schine Chain Theatres, Inc. v. United States, 334 U.S. 110, 128 (1948); SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir. 1980); Handler v. SEC, 610 F.2d 656, 659 (9th Cir. 1979); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 390-91 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971). See also Farrand, *supra* note 2, at 1781, 1784; Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 395-421 (1964); Mishkin, *The Viciousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797, 799-800 (1957); Comment, *Ancillary Relief*, *supra* note 2, at 741; Comment, *Equitable Remedies*, *supra* note 2, at 1189.

This judicial power, however, is not without limits. The relief ordered may not exceed the boundaries of the legislative purpose even when furthering that purpose,²¹ and it may not surpass its remedial function by conveying punitive implication.²² The SEC, as plaintiff, must demonstrate a clear need for the relief requested.²³ In addition, the courts must balance the harm to competing interests against the benefits to be derived from the proposed resolution.²⁴

The federal courts' ancillary jurisdiction²⁵ supports judicial involvement in corporate structure to address an invasion of a federally protected right.²⁶ Legal theory and precedent²⁷ support court appointment of nonaffiliated directors²⁸ to the extent such action remains within

21. See, e.g., *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 62 (1975); *Whitcomb v. Chavis*, 403 U.S. 124, 161 (1971); Comment, *Ancillary Relief*, *supra* note 2, at 744. The cases cited in note 20 *supra* extend the court's enforcement power beyond that authorized by statute so that relief may be granted to effectuate legislative policy. By implication, then, such relief cannot justifiably eclipse the policy it is intended to serve.

22. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.) ("the SEC may seek other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and is not a penalty assessment"), *cert. denied*, 404 U.S. 1005 (1971); *Beck v. SEC*, 430 F.2d 673, 675 (6th Cir. 1970) (court nullified a Commission order suspending broker because it was punitive and not remedial). See generally 2 J. POMEROY, *supra* note 19, §§ 432-447.

23. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1104 (2d Cir. 1972); *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 181 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1067 (S.D.N.Y. 1973); *SEC v. Golconda Mining Co.*, 327 F. Supp. 257, 259 (S.D.N.Y. 1971). See generally Farrand, *supra* note 2, at 1809; Malley, *supra* note 2, at 54; Comment, *Ancillary Relief*, *supra* note 2, at 755.

24. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970); *DiGiovanni v. Camden Fire Ins. Ass'n*, 296 U.S. 64, 70-72 (1935); *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 54 (7th Cir. 1972); Farrand, *supra* note 2, at 1812-14; Comment, *Ancillary Relief*, *supra* note 2, at 749. In this instance the competing interests are the need to redress an alleged violation by furtherance of congressional purpose opposed by the affront to state corporation law and the principles of shareholder democracy. See notes 126-40 *infra*. Transcending this conflict is the desire to ensure investor confidence, protect shareholder interest, and preserve the integrity of the securities market.

25. See 1 J. POMEROY, *supra* note 19, § 171(1).

26. See, e.g., *Bell v. Hood*, 327 U.S. 678 (1946). The Supreme Court stated:

[W]here federally protected rights have been invaded, it has been the rule from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief. And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.

Id. at 684 (footnotes omitted). See also notes 13-20 *supra* and accompanying text.

27. See cases cited in notes 19 & 20 *supra*.

28. The SEC does not limit its requests to appointment of one or several directors. The various terms entered by courts regarding numbers of appointees are discussed generally at notes 31-33 *infra*.

traditional limitations on equitable relief and is necessary to secure the goals Congress sought in passing the securities laws.²⁹ Whether the judiciary actually endorses the director appointment remedy is uncertain, however, because the corporate defendant's consent to the settlement precludes appellate review on the merits.³⁰

B. *Settlements Affecting the Composition of Corporate Boards*

Consent orders that result in appointment of outside directors conform to no definite pattern. Requirements vary from a specified number of appointees³¹ to a majority of independent directors for the reconstituted board,³² with a few demanding an entirely new group of individuals.³³ Some decrees outline responsibilities for the new board³⁴

29. See notes 18-20 *supra* and accompanying text.

30. See, e.g., *Swift & Co. v. United States*, 276 U.S. 311, 324 (1928); *SEC v. Dennett*, 429 F.2d 1303, 1304 (10th Cir. 1970). See also *Farrand*, *supra* note 2, at 1806, 1809; *Treadway*, *supra* note 2, at 639-40; Comment, *Ancillary Relief*, *supra* note 2, at 740; Comment, *Equitable Remedies*, *supra* note 2, at 1194.

31. See, e.g., *SEC v. Vornado, Inc.*, 24 SEC DOCKET 437, 438 (Lit. Rel. No. 9531) (D.D.C. Dec. 18, 1981) (alleged falsely disclosed and manipulated operating reports—appointment of one director); *SEC v. Allison*, 21 SEC DOCKET 208, 209 (Lit. Rel. No. 9205) (D.D.C. Oct. 16, 1980) (alleged antifraud, registration, and reporting violations—appointment of two directors); *SEC v. International Systems & Controls Corp.*, 18 SEC DOCKET 1410, 1410 (Lit. Rel. No. 8953) (D.D.C. Dec. 17, 1979) (alleged antifraud reporting, proxy, and FCPA violations—appointment of three directors); *SEC v. Fashion Two Twenty, Inc.*, 17 SEC DOCKET 146, 146 (Lit. Rel. No. 8701) (N.D. Ohio Mar. 23, 1979) (failure to disclose personal use of corporate funds—nomination of three independent directors).

32. See, e.g., *SEC v. Covington Bros. Technologies*, 21 SEC DOCKET 903, 904 (Lit. Rel. No. 9253) (S.D.N.Y. Dec. 5, 1980) (alleged antifraud, manipulation, registration, and beneficial ownership reporting violations—company to use best efforts to secure a majority of independent directors); *SEC v. Rusco Indus., Inc.*, 20 SEC DOCKET 683, 684 (Lit. Rel. No. 9129) (C.D. Cal. July 8, 1980) (alleged use of corporate funds for personal gain—restructure of board to achieve independent director majority); *SEC v. Generics Corp. of Am.*, 8 SEC DOCKET 1004, 1004 (Lit. Rel. No. 7224) (D.N.J. Jan. 2, 1976) (alleged antifraud, proxy, and reporting violations—board reconstituted to include a majority of independent directors).

33. See, e.g., *SEC v. Stewart Energy Systems of Idaho, Inc.*, 18 SEC DOCKET 796, 796 (Lit. Rel. No. 8900) (E.D. Wash. Oct. 23, 1979) (alleged registration and antifraud violations—company agreed to appoint a new board, although a minority could have connection with past management); *SEC v. Challenge Homes, Inc.*, 9 SEC DOCKET 291, 291 (Lit. Rel. No. 7324) (N.D. Tex. Mar. 23, 1976) (alleged antifraud violations—order provided for appointment of new board of directors).

34. See, e.g., *SEC v. Koracorp Indus., Inc.*, 16 SEC DOCKET 643, 643 (Lit. Rel. No. 8633) (N.D. Cal. Jan. 3, 1979) (maintain procedures at all directors' meetings that result in review of corporate responsibilities under the federal securities laws); *SEC v. Rousell*, 10 SEC DOCKET 263, 264 (Lit. Rel. No. 7529) (E.D. La. Aug. 19, 1976) (order giving shareholders the opportunity to rescind shares tendered or receive price differential; assign irrevocable proxies to a majority of independent directors for three years); *SEC v. First Mortgage Investors*, 7 SEC DOCKET 856, 856

and others contain no specific directions.³⁵ One typical requirement of these settlements, however, is the creation of one or more board committees comprised of at least a majority of outside directors.³⁶ In addition, the defendant frequently agrees to the appointment of a special counsel who has investigatory and reporting responsibilities independent from the new board.³⁷

The propriety of these additional requirements depends upon the nature of the alleged violations. For example, decrees that call for a majority of independent directors may be justifiable if the conduct of the previous board members was sufficiently harmful to the shareholder and public interests.³⁸ The less the settlement terms relate to the alleged violations, however, the greater the punitive implications.³⁹ Moreover, as the extent of intrusion into internal corporate affairs appears to exceed the seriousness of the misfeasance, the ability of a court to sustain the relief is diminished.⁴⁰

(Lit. Rel. No. 7072) (S.D. Fla. Sept. 8, 1975) (chairman of new executive committee to serve as chief executive officer until new trustees elect CEO—for 18 months CEO must be one of new trustees or approved by Commission).

35. *See, e.g.*, SEC v. Stewart Energy Systems of Idaho, Inc., 18 SEC DOCKET 796 (Lit. Rel. No. 8900) (E.D. Wash. Oct. 23, 1979); SEC v. Invesco Int'l Corp., 12 SEC DOCKET 1369 (Lit. Rel. No. 8031) (N.D. Ga. July 19, 1977); SEC v. Inventive Indus., Inc., 12 SEC DOCKET 808 (Lit. Rel. No. 7959) (S.D. Tex. June 7, 1977); SEC v. Mize, 11 SEC DOCKET 1266 (Lit. Rel. No. 7699) (S.D. Tex. Dec. 20, 1976).

36. *See* notes 47-53 *infra* and accompanying text.

37. *See* notes 54-61 *infra* and accompanying text.

38. *See, e.g.*, SEC v. Rusco Indus., Inc., 20 SEC DOCKET 683 (Lit. Rel. No. 9129) (C.D. Cal. July 8, 1980) (chairman's personal finances substantially benefitted by transactions harmful to the corporation); SEC v. TDA Indus., Inc., 9 SEC DOCKET 534, 535 (Lit. Rel. No. 7369) (S.D.N.Y. Apr. 23, 1976) (directors removed for engineering payment of \$100,000 sham finder's fee to their nominee—court ordered appointment of five independent directors); SEC v. Generics Corp. of Am., 8 SEC DOCKET 1004, 1004 (Lit. Rel. No. 7224) (D.N.J. Jan. 2, 1976) (former chairman's alteration of computer records materially affected financial statements and registration of stock distribution—majority independent directors ordered, board to prevent former chairman from serving as officer or director of corporation). *See also* Sporkin, *supra* note 9, at 123.

39. *See, e.g.*, SEC v. Basic Food Indus., Inc., 15 SEC DOCKET 133, 134 (Lit. Rel. No. 8440) (D.D.C. June 20, 1978) (in addition to disgorgement, director was prohibited from professional association with a public company for nine months and subject to notice requirements for five years); SEC v. Inflight Servs., Inc., 13 SEC DOCKET 633, 634 (Lit. Rel. No. 8182) (S.D.N.Y. Nov. 3, 1977) (former officer enjoined from employment by public company for three and one-half years); SEC v. Brad Ragan, Inc., 11 SEC DOCKET 1113, 1114 (Lit. Rel. No. 7681) (W.D.N.C. Dec. 2, 1976) (former director compelled to disgorge \$18,000 and then enjoined from professional association with any public company for three years).

40. *See* notes 21-24 *supra* and accompanying text.

1. *Decrees That Order a Majority of Independent Directors*

Settlements that call for a majority of independent directors are divisible into three basic groups, each requiring a different degree of Commission involvement. One extreme allows the corporate defendant complete control in selecting a new majority,⁴¹ while the other requires Commission approval of every new director.⁴² The third format is a hybrid whereby the Commission approves of a certain number of directors and the corporation is responsible for securing the remainder.⁴³

As the corporation's authority over the selection process increases, there is less conflict between the settlement and principles of state law and shareholder democracy.⁴⁴ Although the bluntness of SEC intrusion into internal corporate affairs is thus cushioned, courts nonetheless should closely scrutinize the arrangement.⁴⁵ The facts of the case must convince the court that such relief is necessary to remedy the past misconduct and to protect against future wrongdoing.⁴⁶

2. *Committee Mandates*

One form of additional relief, which supplements the appointment of directors, requires the defendant to establish a board committee with specified duties. These orders require that outside directors compose either a majority⁴⁷ or an entirety⁴⁸ of the committee membership.

41. *See, e.g.*, SEC v. Isomedics, Inc., 20 SEC DOCKET 873 (Lit. Rel. No. 9147) (S.D.N.Y. July 29, 1980); SEC v. Invesco Int'l Corp., 12 SEC DOCKET 1369 (Lit. Rel. No. 8031) (N.D. Ga. July 19, 1977); SEC v. Bio-Medical Sciences, Inc., 6 SEC DOCKET 203 (Lit. Rel. No. 6700) (S.D.N.Y. Jan. 28, 1975).

42. *See, e.g.*, SEC v. Brad Ragan, Inc., 11 SEC DOCKET 1113 (Lit. Rel. No. 7681) (W.D.N.C. Dec. 2, 1976); SEC v. Eastern Freightways, Inc., 8 SEC DOCKET 517, (Lit. Rel. No. 7171) (D.D.C. Nov. 19, 1975).

43. *See, e.g.*, SEC v. Emersons Ltd., 9 SEC DOCKET 667, 668 (Lit. Rel. No. 7392) (D.D.C. May 11, 1976).

44. State corporation codes generally outline a procedure for replacement of directors by an internal corporate mechanism. *See* note 126 *infra*.

45. *See* notes 21-24 *supra* and accompanying text.

46. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964) (importance of analysis of particular fact pattern), *See also* note 134 *infra* and accompanying text.

47. *See, e.g.*, SEC v. Diagnostic Data, Inc., 23 SEC DOCKET 113, 114 (Lit. Rel. No. 9394) (D.D.C. July 15, 1981); SEC v. Isomedics, Inc., 20 SEC DOCKET 873, 873 (Lit. Rel. No. 9147) (S.D.N.Y. July 29, 1980); SEC v. Fashion Two Twenty, Inc., 17 SEC DOCKET 146, 147 (Lit. Rel. No. 8701) (N.D. Ohio Mar. 23, 1979); SEC v. Emersons Ltd., 9 SEC DOCKET 667, 668 (Lit. Rel. No. 7392) (D.D.C. May 11, 1976).

48. *See, e.g.*, SEC v. Covington Bros. Technologies, 21 SEC DOCKET 903, 904 (Lit. Rel. No.

Many specify that only the newly appointed directors are eligible for selection.⁴⁹

The committees serve to remedy problems raised in the SEC's complaint and to ensure against recurrence of the questioned activity. Litigation and claims committees are directed to bring charges, when appropriate, against misfeasant personnel and to negotiate settlements of third party claims against the corporation.⁵⁰ Transaction review committees are authorized to rescind or modify improper corporate dealings and, in certain instances, must approve proposed transactions.⁵¹ Executive and audit committees are delegated broad oversight authority that frequently includes the above responsibilities as well as development of corporate policies that will result in compliance with the securities laws and prevent other wrongdoing.⁵²

Settlements requiring board committees should encounter less judicial resistance because state corporation codes do not address the issue and shareholders traditionally have not had voting power in this area.⁵³ Even though the SEC arguably is attempting to control corporate policy, as long as the duties include remediation and prevention, committee mandates are justifiable relief.

9253) (S.D.N.Y. Dec. 5, 1980); SEC v. Rusco Indus., Inc., 20 SEC DOCKET 683, 684 (Lit. Rel. No. 9129) (C.D. Cal. July 8, 1980); SEC v. Koracorp Indus., Inc., 16 SEC DOCKET 643, 643 (Lit. Rel. No. 8633) (N.D. Cal. Jan. 3, 1979).

49. See, e.g., SEC v. International Systems & Controls Corp., 18 SEC DOCKET 1410, 1410 (Lit. Rel. No. 8953) (D.D.C. Dec. 17, 1979); SEC v. Rapid-American Corp., 18 SEC DOCKET 149, 150 (Lit. Rel. No. 8841) (D.D.C. Aug. 16, 1979); SEC v. Houston Complex, Inc., 17 SEC DOCKET 792, 793 (Lit. Rel. No. 8766) (D. Nev. May 29, 1979).

50. See, e.g., SEC v. Allison, 21 SEC DOCKET 208, 209 (Lit. Rel. No. 9205) (D.D.C. Oct. 16, 1980); SEC v. Inflight Servs., Inc., 13 SEC DOCKET 633, 633 (Lit. Rel. No. 8182) (S.D.N.Y. Nov. 3, 1977); SEC v. Crown Corp., 9 SEC DOCKET 235, 236 (Lit. Rel. No. 7311) (D. Hawaii Mar. 12, 1976).

51. See, e.g., SEC v. Catawba Corp., 23 SEC DOCKET 1427, 1428 (Lit. Rel. No. 9488) (D.D.C. Nov. 2, 1981); SEC v. Rapid-American Corp., 18 SEC DOCKET 149, 150 (Lit. Rel. No. 8841) (D.D.C. Aug. 16, 1979); SEC v. Montauk Corp., 15 SEC DOCKET 422, 423 (Lit. Rel. No. 8475) (D.D.C. July 25, 1978); SEC v. Continental Connector Corp., 13 SEC DOCKET 358, 359 (Lit. Rel. No. 8155) (D.D.C. Oct. 13, 1977).

52. See, e.g., SEC v. Covington Bros. Technologies, 21 SEC DOCKET 903, 904 (Lit. Rel. No. 9253) (S.D.N.Y. Dec. 5, 1980); SEC v. International Systems & Controls Corp., 18 SEC DOCKET 1410, 1410 (Lit. Rel. No. 8953) (D.D.C. Dec. 17, 1979); SEC v. Houston Complex, Inc., 17 SEC DOCKET 792, 793 (Lit. Rel. No. 8766) (D. Nev. May 29, 1979); SEC v. Marlene Indus. Corp., 17 SEC DOCKET 406, 406 (Lit. Rel. No. 8733) (S.D.N.Y. Apr. 26, 1979); SEC v. Fashion Two Twenty, Inc., 17 SEC DOCKET 146, 147 (Lit. Rel. No. 8701) (N.D. Ohio Mar. 23, 1979).

53. See, e.g., CAL. CORP. CODE § 304 (Deering 1977); DEL. CODE ANN. tit. 8, § 141(c) (1974); N.Y. BUS. CORP. LAW § 712 (Consol. 1976); OHIO REV. CODE ANN. § 1701.63 (Page 1978). See also ABA-ALI MODEL BUS. CORP. ACT § 42 (1980).

3. *Independent Special Counsel*

A second form of supplemental relief is the appointment of special counsel. The decree may charge this individual with specific, limited responsibilities⁵⁴ or may empower him to conduct a far-reaching investigation into any matters deemed appropriate.⁵⁵ In all cases, the special counsel must file reports with the Commission and the court.⁵⁶ The individual may take legal action, but only with approval of a board committee or the entire board.⁵⁷ In spite of this limitation, some settlements grant counsel more expansive authority, thereby placing the individual outside the board's control.⁵⁸ Whether the board or the court appoints the special counsel,⁵⁹ there is little justification for a settlement term that makes one person independently accountable to the SEC.⁶⁰ After securing the appointment of independent directors, the Commission rarely can demonstrate a clear need sufficient to support the appointment of a special counsel.⁶¹ More significantly, if the Com-

54. *See, e.g.*, SEC v. International Systems & Controls Corp., 18 SEC DOCKET 1410 (Lit. Rel. No. 8953) (D.D.C. Dec. 17, 1979); SEC v. Brad Ragan, Inc., 11 SEC DOCKET 1113 (Lit. Rel. No. 7681) (W.D.N.C. Dec. 2, 1976).

55. *See, e.g.*, SEC v. Rusco Indus., Inc., 20 SEC DOCKET 683, 684 (Lit. Rel. No. 9128) (D.D.C. July 3, 1980) (special counsel to supervise audit committee's investigation of allegations); SEC v. Stewart Energy Systems, Inc., 18 SEC DOCKET 796, 796 (Lit. Rel. No. 8900) (E.D. Wash. Oct. 23, 1979) (special agent to report and recommend on the amount of disgorgement).

56. *See, e.g.*, SEC v. Ormand Indus., Inc., 12 SEC DOCKET 415, 416 (Lit. Rel. No. 7910) (D.D.C. May 10, 1977) (investigation into any matters the special counsel deems appropriate); SEC v. Eastern Freightways, Inc., 8 SEC DOCKET 517, 517 (Lit. Rel. No. 7171) (D.D.C. Nov. 19, 1975) (investigate all matters special counsel deems appropriate). This feature is particularly susceptible to criticism because of the freedom it affords to the special counsel. As independence from board control increases, the special counsel begins to take on the qualities of an SEC agent. Such a development is unwarranted, even though a court has broad equitable power to grant ancillary relief.

57. *See, e.g.*, SEC v. Inflight Servs., Inc., 13 SEC DOCKET 633 (Lit. Rel. No. 8182) (S.D.N.Y. Nov. 3, 1977); SEC v. Crown Corp., 9 SEC DOCKET 235 (Lit. Rel. No. 7311) (D. Hawaii Mar. 12, 1976).

58. *See, e.g.*, SEC v. Stewart Energy Systems, Inc., 18 SEC DOCKET 796, 796 (Lit. Rel. No. 8900) (E.D. Wash. Oct. 23, 1979) (agent will recommend to court extent to which investors should get equity position); SEC v. Ormand Indus., Inc., 12 SEC DOCKET 415, 416 (Lit. Rel. No. 7910) (D.D.C. May 10, 1977) (counsel not required to report to board); SEC v. Crown Corp., 9 SEC DOCKET 235, 235 (Lit. Rel. No. 7311) (D. Hawaii Mar. 12, 1976) (same).

59. *Compare* SEC v. Emersons Ltd., 9 SEC DOCKET 667, 668 (Lit. Rel. No. 7392) (D.D.C. May 11, 1976) (counsel appointed by majority of independent directors) *with* SEC v. Generics Corp. of Am., 8 SEC DOCKET 1004, 1004 (Lit. Rel. No. 7224) (D.N.J. Jan. 2, 1976) (counsel appointed by court).

60. *See* notes 55 & 58 *supra*.

61. *See* note 23 *supra* and accompanying text.

mission places what may be analogous to its own agent in a position of corporate power, the court appointment of directors may be an unnecessary remedy.

C. *Practical Aspects of the Consent Decree*

Settlement of SEC allegations by consent involves negotiation between the Commission's Enforcement Division and representatives of the corporation.⁶² Although the opportunity to discuss alternatives and develop awareness of respective concerns is constructive, the Commission exercises substantial leverage in determining the requirements of the decree.⁶³ Nonetheless, out-of-court disposition of the claims frequently is advantageous to the corporation.

Even when corporations have a potentially successful defense, they are often reluctant to resist Commission charges. First, litigation costs, both in monetary outlay and in management time, are significant.⁶⁴ Second, the adverse publicity of trial proceedings is undesirable.⁶⁵ Third, and most important, the findings of fact that lead to an unfavorable decision may give rise to indefensible private actions seeking large damage awards.⁶⁶ These practical considerations operate to force the consent decree process upon corporations unless the Commission's claims are completely groundless.⁶⁷

The SEC is similarly eager to settle by consent. Time and budgetary limitations make out-of-court settlements attractive,⁶⁸ and the Commis-

62. See Farrand, *supra* note 2, at 1784, 1796, 1806 n.142; Wolfson, *supra* note 8, at 24; Comment, *Equitable Remedies*, *supra* note 2, at 1192.

63. See Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1252 (1977); Farrand, *supra* note 2, at 1784, 1796 n.90, 1806 n.142.

64. See Merrifield, *supra* note 11, at 1627 n.160; Wolfson, *supra* note 8, at 19; Comment, *Equitable Remedies*, *supra* note 2, at 1192.

65. See Merrifield, *supra* note 11, at 1627 n.160; Wolfson, *supra* note 8, at 19; Comment, *Equitable Remedies*, *supra* note 2, at 1192.

66. See Coffee, *supra* note 63, at 1252 n.547; Merrifield, *supra* note 11, at 1627 n.160; Wolfson, *supra* note 8, at 19; Comment, *Equitable Remedies*, *supra* note 2, at 1192.

67. Initially, the Schlitz Brewing Co. decided to litigate Commission charges alleging illegal kickbacks. See *SEC Accuses Schlitz of Making at Least \$3 Million In Illegal Payments*, Wall St. J., Apr. 8, 1977, at 5, col. 2. Later the company settled the case by a consent decree calling for appointment of a special review person, maintenance of an audit committee composed of independent directors, and maintenance of a policy prohibiting questionable payments. *SEC v. Schlitz Brewing Co.*, 15 SEC DOCKET 278, 278 (Lit. Rel. No. 8460) (E.D. Wis. July 7, 1978). See note 92 *infra*.

68. See Wolfson, *supra* note 8, at 19; Comment, *Equitable Remedies*, *supra* note 2, at 1192.

sion may hesitate to pit its relatively young, inexperienced staff against a corporation's highly skilled and seasoned trial attorneys.⁶⁹ Beyond these administrative concerns, the corporation's consent will subject the terms desired by the SEC to less judicial scrutiny.⁷⁰

Use of the consent decree to change the composition of corporate boards has been accepted by both corporations and the SEC and approved by the judiciary.⁷¹ Although consent by the corporation is often a prudent alternative, this settlement mechanism still carries with it profound implications.⁷²

II. SEC USE OF THE REMEDY

Although the Commission has not attempted to develop standards for using the director appointment remedy,⁷³ it nonetheless has enthusiastically adopted the concept.⁷⁴ With increased public awareness of

69. See Wolfson, *supra* note 8, at 19.

70. See Farrand, *supra* note 2, at 1805-96; Comment, *Ancillary Relief*, *supra* note 2, at 740. See also notes 30 *supra* & 100-03 *infra* and accompanying text.

71. Judicial approval was not always so readily obtainable. One of the earlier consent settlements, SEC v. Mattel, Inc., 5 SEC DOCKET 241 (Lit. Rel. No. 6531) (D.D.C. Oct. 2, 1974), encountered difficulty from the bench. It was only after extensive argument by the Commission and the defense counsel that Judge Gesell accepted the decree in principle. He initially believed that court involvement in director appointments was improper and approved the settlement only with certain modifications. One of Judge Gesell's requirements was that the case be transferred to California, the location of Mattel. The California judge also resisted court oversight of corporate affairs. His approval came after additional argument by both parties and upon agreement that the court would not endorse specific directors. See Mathews, *supra* note 2, at 1328.

As use of the remedy developed, however, it experienced less judicial resistance. Certain far-reaching settlements apparently were approved without hesitation by the court. See, e.g., SEC v. Eastern Freightways, Inc., 8 SEC DOCKET 517 (Lit. Rel. No. 7171) (D.D.C. Nov. 19, 1975). When aspects of the *Mattel* settlements were appealed, *Handler v. SEC*, 610 F.2d 656 (9th Cir. 1979), the court disallowed the attack on the original order. See notes 106-11 *infra* and accompanying text.

72. See Wolfson, *supra* note 8, at 20. Even with consent of the defendant and approval of the court, such government intervention in private corporations runs counter to the principles of free enterprise. See generally COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE, ALI-ABA SYMPOSIUMS 1977-78 (1979) [hereinafter cited as COMMENTARIES] and the following articles therein: Coombe, *Change Is Needed—From Within*, at 196; Farrell, *Corporations Are Already Overgoverned*, at 188; Greenough, *Somebody Ought To Be on the Side of Corporations*, at 533; and Ruckleshaus, *Federal Charter Threatens To Discard the Baby With the Bathwater*, at 349.

73. The flexibility available in fashioning an appropriate remedy for corporate reform is a distinct benefit derived from the consent decree process. Sporkin, *supra* note 9, at 122 (molding of remedies important because parties have opportunity to be creative and helpful to investing public).

74. After several early experiences with director appointments, the Commission began to view the remedy as superior to the receivership that had often been sought in the past. In addition to offering the public protection as good as or better than a receiver, new directors allowed "the

corporate misconduct and the Commission's consequent determination to take an active role in corporate governance,⁷⁵ the boardroom predictably became a focal point for reform. Settlements appointing independent directors, and even issuing explicit directives to an entire board, became more prevalent.⁷⁶ The SEC, by extended application of the remedy and utilization of other terms ancillary to the appointment of directors, has gone beyond the legitimate goal of effectuating the congressional purpose underlying the securities laws.

A. *The Commission's Role in Corporate Governance*

An increased sense of social responsibility, consistent with the national sentiment prevalent in the late 1960s and early 1970s, may explain the Commission's heightened concern with corporate governance. More particularly, SEC initiative in this area grew from the discovery of, and subsequent public outcry against, the corporate improprieties during the 1972 presidential election campaign and the disclosure of misappropriation of corporation funds in the form of questionable payments made both domestically and abroad.⁷⁷ The Commission responded by implementing its management fraud program,⁷⁸ which marked the beginning of a period during which the SEC became more involved and influential in internal corporate affairs.⁷⁹

company to remain viable and avoid various acceleration events that sometimes result from the appointment of a receiver" (e.g., the calling of bank loans). Sporkin, *supra* note 9, at 123.

75. It has become increasingly clear that the Commission is no longer content with its traditional role of abstention from interference with corporate governance and is restlessly seeking to affect the manner in which corporations are governed, the relationships between their managements and shareholders, the constitution of their boards of directors, and the manner in which the various parts of the corporate community conduct themselves and relate to each other.

Sommer, *supra* note 5, at 121. See generally Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173 (1981); Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183 (1979); Rosenfeld, *Corporate Governance*, 7 SEC. REG. L.J. 171 (1979).

76. See, e.g., SEC v. Basic Food Indus., Inc., 15 SEC DOCKET 133 (Lit. Rel. No. 8440) (D.D.C. June 20, 1978). In *BFI* the settlement terms contained a provision directing the defendants to make either a tender offer or a cash merger proposal to shareholders at a specified price. Following these transactions, if BFI remained a public company the order required the appointment of three independent directors satisfactory to the Commission.

77. See Coffee, *supra* note 63, at 1115-16; Sommer, *supra* note 5, at 115.

78. See, e.g., Freeman, *The Legality of the SEC's Management Fraud Program*, 31 BUS. LAW. 1295 (Special Issue 1976).

79. See note 75 *supra* and accompanying text. See also Sporkin, *supra* note 9, at 122 (leaving certain remedies to the private bar detrimental to public interest and no longer efficient—SEC will continue to seek expanded orders).

Initially, the Commission contemplated developing guidelines for the conduct of corporate directors.⁸⁰ The plan was later abandoned due to concern with intrusion into areas of state law and to difficulties with confining the standards to securities-related matters.⁸¹ Instead, the SEC employed less official methods to convey its attitude.⁸²

In 1977, though, the Commission began to encourage the New York Stock Exchange to consider a rule requiring listed companies to maintain an audit committee of the board that would be comprised of directors not affiliated with management.⁸³ The Exchange later adopted this concept.⁸⁴

The Commission also rekindled its effort to outline the duties of directors and the proper standards they should employ.⁸⁵ The use of liti-

80. In 1973 SEC Chairman Cook outlined the need to establish standards for the conduct of directors in securities matters. *See* Corporate Directors to Fulfill Responsibilities or Risk Liability, Address before the Southern Methodist University School of Business Administration, SEC News Release, April 6, 1973, at 4; [1973] SEC. REG. & L. REP. (BNA) No. 197 at A-7 (April 11, 1973).

81. Though he had originally reaffirmed the commitment to develop guidelines, Chairman Garrett withdrew the effort. *See* Corporate Directors and the Federal Securities Laws, Address before the Thirteenth Annual Corporate Counsel Institute, Northwestern University School of Law, SEC News Release, Oct. 3, 1974, at 4-5; [1974] SEC. REG. & L. REP. (BNA) No. 272 at A-11 (Oct. 9, 1974).

In an earlier case, the Commission was presented with the opportunity to address the issue of director standards. It declined to enunciate criteria for normative director conduct. *In re* Franchard Corp., 42 S.E.C. 163, 176 (1964) (Securities Act does not purport to define such regulatory standards—diligence required to be evaluated in light of state and common law standards).

82. Former Commissioner Sommer has outlined the methods whereby the SEC promotes its policies. *See* Sommer, *supra* note 5, at 125-44. These approaches are (1) "jawboning" (Commissioner statements), (2) litigation and settlement, (3) "coaxing" (voluntary disclosure), (4) statutory transference, (5) rule making (direct and indirect), and (6) pronouncement (in the context of settlements).

83. Letter from SEC Chairman Roderick M. Hills to Mr. William M. Batten, Chairman of the New York Stock Exchange (May 11, 1976), *reprinted in* [1976] SEC. REG. & L. REP. (BNA) No. 353 (special supplement), at 44-45 (May 19, 1976).

84. NEW YORK STOCK EXCHANGE COMPANY MANUAL, at A-29 (1978); 2 NYSE GUIDE (CCH) ¶ 2495H (1977). *See also* SEC Exch. Act. Rel. No. 13346, 11 SEC DOCKET 1945 (Mar. 9, 1977).

85. *See, e.g.,* SEC v. Shiell, 11 SEC DOCKET, 1664, 1665 (Lit. Rel. No. 7763) (N.D. Fla. Jan. 31, 1977) (directors' unwarranted reliance on corporate officers amounted to false representation of the exercise of proper control and authority over management); *In re* National Tel. Co., SEC Exch. Act Rel. No. 14380, 13 SEC DOCKET 1393, 1396 (Jan. 16, 1978) (outside directors should be expected to maintain a general familiarity with company's public communications); *In re* Stirling Homex Corp., SEC Exch. Act Rel. No. 11516, 7 SEC DOCKET 298, 299 (July 2, 1975) (directors' acceptance of superficial management answers did not provide shareholders with protection in fact).

Section 21(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(a) (1976), authorizes the

gation and settlement, however, became the most effective means for furthering SEC influence in corporate governance.⁸⁶ Many investigations resulted in consent decrees requiring both court appointment of independent directors satisfactory to the SEC and other forms of boardroom reorganization.

B. *A Broader SEC Policy Has Engulfed The Director Appointment Remedy*

In *SEC v. Clinton Oil Co.*⁸⁷ the Commission first sought appointment of a receiver to take control of the business.⁸⁸ The court refused and instead supervised replacement of a majority of Clinton's board.⁸⁹ Throughout the remainder of the 1970s, when confronted with securities law violations, the SEC often requested and was repeatedly granted relief that focused on court-ordered changes in board composition.⁹⁰ The remedy developed simultaneously with an apparent need to ad-

Commission to issue reports concerning its investigations and statements made by persons subject to investigation. The Commission has announced its intention to continue issuing such reports "to help . . . in administering its responsibilities under the federal securities laws . . . [and to] make available information and provide disclosure in a simple and effective way." SEC Exch. Act Rel. No. 15664, 17 SEC DOCKET 18, 19 (Mar. 21, 1979).

The § 21(a) power gives the Commission substantial latitude in exposing information generated through its investigatory function and in espousing principles and theories. See Berkley & Smith, *Recent SEC Developments—Section 21(a) Reports: The Commission Continues to Set New Standards for Corporate Directors*, 6 SEC. REG. L.J. 255, 255, 259 (1978); Seamons, *The SEC and Corporate Governance*, 60 CHI. B. REC. 262, 265-68 (1979). At least one Commissioner believed that publication of information should occur only under limited circumstances. See *Separate Statement of Commissioner Karmel*, SEC Exch. Act Rel. No. 15664, *supra*, at 20. The *Stirling Homex* and *National Telephone* releases, *supra*, were made under § 21(a) authority.

86. See Sommer, *supra* note 5, at 130. See also SEC DIVISION OF CORPORATION FINANCE, 96TH CONG., 2D SESS., STAFF REPORT ON CORPORATE ACCOUNTABILITY 752-53 (Comm. Print 1980) [hereinafter cited as CORPORATE ACCOUNTABILITY].

87. 1 SEC DOCKET No. 11, at 23 (Lit. Rel. No. 5798) (D. Kan. Mar. 20, 1973).

88. 1 SEC DOCKET No. 4, at 20 (Lit. Rel. No. 5715) (D. Kan. Jan. 30, 1973). Clinton's management was charged with omitting material facts from public announcements; using proceeds from insider sales of stock, received in the first place by "exchange" with the company for outside oil interests, to pay for these same interests; and price manipulation of Clinton stock. Treadway, *supra* note 2, at 643.

89. 1 SEC DOCKET No. 11, at 23 (Lit. Rel. No. 5798) (D. Kan. Mar. 20, 1973). Rather than liquidate the company's assets, the court hoped that independent management would maintain Clinton as a viable corporation. Treadway, *supra* note 2, at 644. See also Sporkin, *supra* note 9, at 123.

90. These orders were issued only with consent of the corporation. See notes 62-72 *supra* and accompanying text. For a brief description of the way in which changes were required, see cases cited in notes 31-61 *supra*.

dress issues of corporate reform.⁹¹ Lack of an articulated standard and inconsistent application of the remedy⁹² indicate that the SEC employed the remedy in pursuit of a policy not contemplated by Congress in the enactment of the securities laws.

Expansion of relief beyond that expressly authorized by statute is based on the courts' equity power to assist in the realization of congressional purpose.⁹³ Congress intended the SEC to infuse integrity into the distribution and trading of securities and to require disclosure designed to ensure fully informed investment decisions and effective exercise of shareholder rights.⁹⁴ Congress did not intend, except in the Investment Advisor's Act of 1940,⁹⁵ for the securities laws to regulate the composition of corporate boards. To the extent that appointment of one or even several directors can remedy and prevent specific securities law violations, congressional intent is effectively realized. Open-ended orders that require a majority of new, nonaffiliated directors, however, present an altogether different situation that implies a farther reaching Commission purpose.⁹⁶

91. See notes 77-86 *supra* and accompanying text. Focus on the boardroom to expedite this reform was called for by many commentators. See generally C. BROWN, PUTTING THE CORPORATE BOARD TO WORK (1976); A. COHEN & R. LOEB, DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS (1978); COMMENTARIES, *supra* note 72; R. MUELLER, NEW DIRECTIONS FOR DIRECTORS (1978); R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976); C. STONE, WHERE THE LAW ENDS (1975).

92. Compare SEC v. Jos. Schlitz Brewing Co., 15 SEC DOCKET 278, 278 (Lit. Rel. No. 8460) (E.D. Wis. July 7, 1978) (company charged with not disclosing \$3 million in questionable payments—consented to appointment of person to review company's own investigation, maintenance of previously established audit committee, and maintenance of policy prohibiting payments) with SEC v. Emersons Ltd., 9 SEC DOCKET 667, 668 (Lit. Rel. No. 7392) (D.D.C. May 11, 1976) (company charged with taking payments from Schlitz and with other accounting improprieties—consented to eventual appointment of a majority of independent directors, new chief executive and financial officers with no prior affiliation, a special financial reporting committee, and a special counsel). One possible explanation for the disparity in treatment is that Schlitz had originally planned to litigate the case. See note 67 *supra*. Another explanation may be that at time of the Commission's action Schlitz had a majority of independent directors, see 1977 MOODY'S INDUSTRIAL MANUAL 3870, while Emersons did not, see 1976 MOODY'S OTC INDUSTRIAL MANUAL 517 & 1975 MOODY'S OTC INDUSTRIAL MANUAL 380.

93. See notes 13-30 *supra* and accompanying text.

94. See Sommer, *supra* note 5, at 118.

95. Section 10(a), 15 U.S.C. § 80a-10(a) (1976), requires that 40% of an investment company's board be independent.

96. This has not deterred the Commission from pursuing a policy aimed at independent boards. "[T]he most important job we have to do is create a truly independent character on those boards of directors, both from a remedial standpoint, when we found the problem, and from a perspective standpoint." *Corporate Rights and Responsibilities: Hearings Before the Senate Comm.*

The consent decree process, interpreted to have special sanctuary from judicial review,⁹⁷ has allowed the SEC to use the director appointment remedy in implementing a broad policy of corporate reform. The Commission's goals are laudable, and increased corporate accountability is a beneficial outcome.⁹⁸ When lifted from its legal foundation, however, the remedy cannot withstand close scrutiny.⁹⁹

C. *Judicial Responses*

The entry of a consent decree is an exercise of judicial power.¹⁰⁰ The order is appealable, however, only on grounds of fraud, lack of subject matter jurisdiction, or lack of actual consent.¹⁰¹ These decrees reflect neither judicial consideration of the limitations on a court's equity power nor a balancing of the competing interests.¹⁰² Consequently, an order requiring the court to appoint outside directors pursuant to a consent decree by no means signifies judicial acceptance of this

on Commerce, 94th Cong., 2d Sess. 316-17 (1976) (statement by Roderick M. Hills, then Chairman of the SEC).

The SEC sees outsider directors as "private securities commissioners" who supplement the limited resources of the Commission. It believes that requiring the appointment of independent directors is more effective than enjoining future wrongdoing, and that that sanction is not so severe as to prevent the company from carrying on its business. Interview with Edward D. Herlihy, Branch Chief, Division of Enforcement, SEC, Washington, D.C. (Sept. 8, 1977); Interview with Theodore A. Levine, Assistant Director, Division of Enforcement, SEC (Nov. 9, 1977). See generally Loo & Ratner, *The SEC's Role in Director Selection*, in PRACTISING LAW INSTITUTE, DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS 144-45 (1976); Sporkin, *SEC Developments in Litigations and the Moulding of Remedies*, 29 BUS. LAW. 121 (1974); Comment, *Equitable Remedies in SEC Enforcement Proceedings*, 123 U. PA. L. REV. 1188, 1210-14 (1975).

Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581, 592 n.44 (1978). See notes 41-46 *supra* and accompanying text.

97. See notes 100-03 *infra* and accompanying text.

98. Discussion of the effectiveness of independent corporate boards at achieving reform and increasing accountability is beyond the scope of this Note.

99. See notes 21-24 *supra* and accompanying text.

100. See, e.g., *United States v. Carter Prods., Inc.*, 211 F. Supp. 144, 147 (S.D.N.Y. 1962). Cf. *SEC v. Thermodynamics, Inc.*, 319 F. Supp. 1380, 1382 (D. Colo. 1970) (approval of consent judgment adjudicates plaintiff's relief, which is essential element of any judgment), *aff'd*, 464 F.2d 457 (10th Cir. 1972), *cert. denied*, 410 U.S. 927 (1973).

101. See, e.g., *Swift & Co. v. United States*, 276 U.S. 311, 324 (1928); *SEC v. Dennett*, 429 F.2d 1303, 1304 (10th Cir. 1970). See also Comment, *Equitable Remedies*, *supra* note 2, at 1193.

102. See Block & Barton, *Administrative Proceedings to Enforce the Foreign Corrupt Practices Act*, 7 SEC. REG. L.J. 40, 49 n.31 (1979); Farrand, *supra* note 2, at 1806, 1809; Treadway, *supra* note 2, at 639-40. Cf. Coffee, *supra* note 63, at 1252 (overwhelming SEC leverage in settlements deters challenge from corporate defendants); Comment, *Ancillary Relief*, *supra* note 2, at 740 (due to nature of consent settlements relative merits of relief not fully argued before the courts).

remedy.¹⁰³

Two cases, however, have sustained the validity of intrusion into corporate affairs when consented to by the defendant. Both *SEC v. Handler*¹⁰⁴ and *International Controls Corp. v. Vesco*¹⁰⁵ denied collateral attacks on court appointment of corporate officials. In *Handler*, one former and two current directors of Mattel, Inc. challenged an order in which a special counsel was appointed by a majority of new directors,¹⁰⁶ themselves serving by the terms of a consent decree.¹⁰⁷ The complaint alleged a violation of article III of the Constitution in that the SEC delegated governmental power to a private person.¹⁰⁸ Holding that a district court is "inherently invested with broad equitable powers . . . [i]n order to give effect to remedial statutes,"¹⁰⁹ the Ninth Circuit affirmed dismissal of the suit.¹¹⁰ Significantly, the court viewed the appointment of special counsel by consent as a "self-initiated corporate investigation."¹¹¹

In *Vesco*, the corporation eventually agreed to appointment of a new board of directors and special counsel instead of the receiver the SEC initially sought.¹¹² The former controlling shareholder challenged this settlement in state court,¹¹³ claiming that the previous directors abdicated their responsibility by accepting these terms.¹¹⁴ The special counsel obtained a federal court injunction against prosecution of the state actions,¹¹⁵ and the Second Circuit affirmed those provisions of the

103. Block & Barton, *supra* note 102, at 49 n.31; Sommer, *supra* note 5, at 129.

104. 610 F.2d 656 (9th Cir. 1979).

105. 490 F.2d 1334 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974).

106. 610 F.2d at 657.

107. SEC v. Mattel, Inc., 5 SEC DOCKET 241 (Lit. Rel. No. 6531) (D.D.C. Oct. 2, 1974). The initial consent decree called for the appointment of two unaffiliated directors satisfactory to the Commission. SEC v. Mattel, Inc., 4 SEC DOCKET 724, 724 (Lit. Rel. No. 6467) (D.D.C. Aug. 8, 1974). Subsequent to the issuance of this order, the board voluntarily disclosed to the SEC supplementary information indicating additional material misstatements. The amended order, 5 SEC DOCKET at 241, required a majority of independent directors. The two current directors in *Handler* had voted in favor of accepting both settlements. 610 F.2d at 657.

108. 610 F.2d at 658-59.

109. *Id.* at 659.

110. *Id.* at 660.

111. *Id.* at 659.

112. *International Controls Corp. v. Vesco*, 490 F.2d 1334, 1338-40 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974).

113. *Id.* at 1352. The challenger was the controlling shareholder at the time the consent decree was issued.

114. *Id.*

115. *Id.*

injunction that barred interference with the court-appointed directors.¹¹⁶

By contrast, courts have denied the SEC's request for court appointment of independent directors in two cases litigated on their merits. In *SEC v. Falstaff Brewing Corp.*¹¹⁷ the court issued injunctions permanently enjoining the corporation and affiliated persons from future violations of various securities laws.¹¹⁸ Although finding that Falstaff had committed the alleged violations, the court balanced the interests involved and concluded that deterioration of Falstaff's internal corporate structure by appointment of additional independent directors was unwarranted.¹¹⁹ The court noted that "in formulating such remedies, . . . [it] should not, without considerable justification, impose a remedy which would in effect regulate areas traditionally left to internal corporate management."¹²⁰

The court in *SEC v. American Realty Trust*¹²¹ issued a similar response, albeit by dictum. Although ultimately reversed on its requirement of scienter for the alleged violation, the district court clearly stated it would entertain appointment of corporate officials only in the most extreme cases.¹²² The court questioned its authority to "infringe

116. *Id.* Interference with the special counsel was also prohibited.

117. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583 (D.D.C.), *aff'd on other grounds*, 629 F.2d 62 (D.C. Cir. 1980).

118. *Id.* at 94,473. The Commission charged in its complaint, and the court found, that Falstaff and its chairman had violated numerous securities laws. Included were the filing of a materially false and misleading "Schedule 13D" report, a misleading proxy statement, and a factually inaccurate letter with the SEC concerning new independent accountants. Additionally, Falstaff neglected to file certain § 16(a) reports, disregarded its disclosure responsibilities generally, and failed to retain adequate securities counsel. *Id.* at 94,472-73. The court retained jurisdiction in order to implement and carry out the terms of its judgment. *Id.* at 94,475.

119. *Id.* at 94,473-74.

120. *Id.* at 94,473. The court noted that a showing of securities law violations invokes its equity jurisdiction, which in turn gives it considerable latitude in fashioning an appropriate remedy. *Id.* In addition to a request for appointment of independent directors, the Commission sought an order reconstituting Falstaff's audit committee to comprise only independent directors. *Id.* But the court also denied this relief, *id.* at 94,474, even though it had found that Falstaff's previous audit committee existed in name only and that a proxy statement noting the committee's existence was therefore misleading.

121. 429 F. Supp. 1148 (E.D. Va. 1977), *rev'd on other grounds*, 586 F.2d 1001 (4th Cir. 1978).

122. *Id.* at 1178. The Commission's complaint alleged that American Realty Trust and its president filed a fraudulent and misleading prospectus for a \$15 million debenture offering that failed to disclose the complete details of certain loan transactions. Although recognizing that its authority to grant ancillary relief was not expressly limited, the district court dismissed, holding that a showing of scienter is necessary to find a § 17(a) violation. *Id.* at 1171. The Fourth Circuit reversed, ruling that negligence was a sufficient basis. 586 F.2d at 1007. The resulting district

on activities traditionally controlled by the states"¹²³ and concluded that "[e]xcept in the most egregious cases, courts should not interfere with corporate democracy."¹²⁴

The *Vesco* and *Handler* holdings demonstrate that when the corporation consents, court-ordered changes in corporate structure will survive judicial scrutiny. These holdings should not be interpreted, however, as an endorsement of the remedy in its own right.¹²⁵ The disposition of the courts in *Falstaff* and *American Realty*, indicative of judicial response to litigation of director appointment cases, raises issues resolved only by balancing competing interests. Even when corporate defendants agree to settle by consent, courts should still employ equitable balancing.

D. Critical Responses

Critics question the propriety of the court-appointed director remedy for two reasons. First, they see judicial intervention in corporate structure as a dangerous entry into an area traditionally controlled by state law.¹²⁶ The case for federal chartering of corporations, often sponsored

court order of permanent injunction made no mention of the SEC's prior request for ancillary relief, which included removal of the president and appointment of additional trustees. *SEC v. American Realty Trust*, 16 SEC DOCKET 1308 (Lit. Rel. No. 8686) (E.D. Va. Mar. 7, 1978).

123. 429 F. Supp. at 1177-78.

124. *Id.* at 1178.

125. See Farrand, *supra* note 2, at 1797. See also note 103 *supra* and accompanying text.

126. See, e.g., *SEC v. American Realty Trust*, 429 F. Supp. 1148, 1177-78 (E.D. Va. 1977), *rev'd on other grounds*, 586 F.2d 1001 (4th Cir. 1978); Kripke, *supra* note 75, at 192-94; Malley, *supra* note 2, at 59; Rosenfeld, *supra* note 75, at 172; Comment, *Ancillary Relief*, *supra* note 2, at 748. See generally Hetherington, *supra* note 75, at 215.

Corporations are chartered under the provisions of state corporation codes. Consent decrees that affect the composition of corporate boards of directors conflict with these codes in four ways. First, selection of directors is by the corporation's shareholders. Second, the power to remove directors is held by the shareholders or the directors. Third, vacancies are filled by either shareholders or directors for the remainder of the previous director's unexpired term. Finally, an increase in the number of directors can be accomplished by amendment to the bylaws or, where permitted by the charter, director action. See, e.g., CAL. CORP. CODE § 301 (Deering 1977) (shareholder vote to increase number); *id.* § 301(a) (election by shareholders); *id.* § 303 (removal by shareholders); *id.* § 305(a) (vacancies may be filled by directors if bylaws permit, otherwise by shareholders); DEL. CODE ANN. tit 8, § 141(b) (1974) (shareholder vote to increase number); *id.* § 141(d) (election by shareholders); *id.* § 141(k) (removal by shareholders); *id.* § 223(a) (vacancies filled by directors); ME. REV. STAT. ANN. tit. 13-A, § 704(3) (1981) (election by shareholders); *id.* § 706(1)(A) (shareholder vote at annual meeting to increase number); *id.* § 706(1)(B) (vacancies filled by shareholders, and directors if bylaws permit); *id.* § 707 (removal by shareholders or directors); N.Y. BUS. CORP. LAW § 702 (Consol. 1976) (shareholders, and directors if authorized, vote

with staunch support,¹²⁷ has failed to receive the congressional backing necessary for its adoption.¹²⁸ As a consequence, the state legislatures are still the primary means for regulating internal corporate affairs. Second, removing the power to select board members from a company's shareholders directly contravenes the principle of shareholder democracy contemplated by the securities laws¹²⁹ and espoused by the SEC.¹³⁰ In this sense, a fundamental conflict exists in the justification for the remedy: it tends to effectuate one legislative purpose while ig-

to increase number); *id.* § 703 (election by shareholders); *id.* § 705 (vacancies filled by shareholders, and directors if bylaws permit); *id.* § 706 (removal by shareholders).

See also ABA-ALI MODEL BUS. CORP. ACT § 36 (1980) (director election by shareholders); *id.* (amendment of bylaws or articles of incorporation to increase number); *id.* § 38 (vacancies filled by majority of remaining directors); *id.* § 39 (directors removed by shareholder vote).

127. R. NADER, M. GREEN & J. SELIGMAN, *supra* note 91; C. STONE, *supra* note 91; Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Henning, *Federal and Corporation Law: The Chaos Inherent in the Cary Proposal*, 3 SEC REG. L.J. 362 (1976); Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976). See also the following articles in COMMENTARIES, *supra* note 72: Black, *A Call for Federal Fiduciary Standards*, at 234; Blumberg, *A Need for Supplementary National Legislation*, at 343; Metzzenbaum, *Reform is in the Air*, at 507; Ratner, *Regulating Management Through Corporation Law*, at 138; Sachnoff, *The Present System Does Not Prevent Large Scale Fraud*, at 230; Schwartz, *The Paradigm of Federal Chartering*, at 325; Will, *Little Chance of State Action*, at 503.

128. Proposals that advocated federal chartering date back to the constitutional convention. James Madison's proposals were defeated as unnecessary and contributive to development of monopolies. J. MADISON, NOTES ON DEBATES OF THE FEDERAL CONVENTION 638 (1966). In the late 1800s, Congress passed the antitrust laws to thwart the abuses of business power in spite of urgings that federal licensing of corporations be adopted. Watkins, *Federalization of Corporations*, 13 TENN. L. REV. 89, 92 (1935). In the early 1900s several bills authorizing federal incorporation were introduced in Congress, and Presidents Theodore Roosevelt and William Howard Taft also favored the concept. *Id.* at 93; Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 126 (1972). Again in the 1930s, such recommendations were issued. Two Senators were joined by the Federal Trade Commission and the New York Stock Exchange in advocating federal licensing. Sommer, *supra* note 5, at 118. Congress, however, rejected the proposals and instead focused on disclosure as a regulatory mechanism. *Id.* Two bills, introduced in the 96th Congress, would have superseded state corporation codes in many significant areas. The Corporate Democracy Act, H.R. 7010, 96th Cong., 2d Sess. (1980) (introduced by N.Y. Rep. Rosenthal); The Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong., 2d Sess. (1980) (introduced by Ohio Sen. Metzzenbaum). For an article outlining the key features of the two bills, see Trowbridge, *Congress and Corporate Governance*, CORP. DIR., Sept./Oct. 1980, at 21.

129. See SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947) (Congress intended to require opportunity for operation of fair corporate suffrage in enacting Securities Exchange Act of 1934), *cert. denied*, 332 U.S. 847 (1948); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 5, 13 (1934) (with every equity security bought on a public exchange should attach the right of fair corporate suffrage).

130. See, e.g., Securities Exch. Act Rel. No. 16656, 18 SEC DOCKET 997 (Nov. 21, 1979); Securities Exch. Act Rel. No. 16104, 18 SEC DOCKET 91 (Aug. 13, 1979).

noring another distinct goal of the same legislation.¹³¹

The tension between state corporation codes and federal regulatory power cannot be easily resolved. The Supreme Court has indicated that state law may not hinder protection of federal interests.¹³² In the pursuit of federal objectives, however, federal actions must not unduly interfere with legitimate state interests.¹³³ In *Burks v. Lasker* the Court held that when state law is available, a court should apply it, but only to the extent consistent with the federal legislative scheme.¹³⁴ The *Burks* approach, when extended by analogy to the consent decree issue, results in weighing the benefits of director appointments in promoting investor and shareholder protection against the mandate for utilizing shareholder initiative in selecting corporate directors.

Both boardroom policy and corporate suffrage can theoretically promote shareholder interests.¹³⁵ In determining the appropriate balance, then, the court should consider the type of protection the shareholder most desires. Although the debate continues as to the amount of participation in corporate governance the shareholders desire,¹³⁶ there is little doubt that concern for the corporation's economic performance is their paramount consideration.¹³⁷ Complete usurpation of the right to

131. This conflict would tend to instill particular significance in the courts' role of balancing the equities and analyzing the facts of an individual case. See notes 21-24 *supra* and accompanying text.

132. *J.I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964). See also *Levitt v. Johnson*, 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

133. *Younger v. Harris*, 401 U.S. 37, 44 (1971); *De Sylva v. Ballentine*, 351 U.S. 570, 580 (1956).

134. 441 U.S. 471, 480, 486 (1979). In *Burks v. Lasker* the Supreme Court stated: "It is true that in certain areas we have held that federal statutes authorize the federal courts to fashion a complete body of federal law. Corporation law, however, is not such an area." *Id.* at 477 (citations omitted). Thus, although the *Burks* Court cited the proposition in *J.I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964), that "federal law . . . would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law," 441 U.S. at 477 (emphasis added), the Court also noted that "Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute," *id.* at 478. In effect, the Court has directed lower federal courts to engage in a process that attempts to balance equitably the interests of state law (which would not permit federal courts to appoint directors) with the need to redress invasion of a federally protected rights. See note 26 *supra* and accompanying text. This returns the analysis to the language in *Borak* that requires close scrutiny of the particular fact pattern.

135. The potential for increased scrutiny of corporate policy by independent directors combined with the disclosure requirements that support the goal of shareholder participation can serve to deter management misconduct.

136. See CORPORATE ACCOUNTABILITY, *supra* note 86, at 66.

137. See *id.* See generally Coffee, *supra* note 63, at 1259; Soderquist & Vecchio, *Reconciling*

elect directors would prompt shareholder displeasure, but less resentment and perhaps even approval may result if court-appointed directors assist in preserving or restoring a corporation's financial health.¹³⁸

Coupled with this analysis is the recognition that shareholder suffrage has not been an effective means for either preventing corporate wrongdoing or removing misfeasant management.¹³⁹ The proxy rules promulgated under section 14 of the Securities Exchange Act¹⁴⁰ have advanced corporate democracy, but further SEC intervention may be necessary to afford actual protection from securities law violations. The acceptable degree of SEC intervention into corporate affairs and resolution of the conflict between state law and the competing congressional objectives are decisions properly left to the judicial process.

III. MODIFICATION OF THE SEC APPROACH TO THE DIRECTOR APPOINTMENT REMEDY

Indications that the breadth of influence the SEC enjoyed through its enforcement mechanisms in the 1970s would be subject to retrenchment in the 1980s¹⁴¹ have become reality.¹⁴² The process began with Supreme Court limitations on the reach of the federal securities

Shareholders' Rights and Corporate Responsibility: New Guidelines for Management, 1978 DUKE L. J. 819, 824; Varner, *The Role and Function of Corporate Directors*, Williams World, 3d Quarter Report 1980, at 23, 25. See also *Shareowner Attitude Survey*, Opinion Research Corp. Study 63,058 (1978).

138. Shareholders may be willing to engage in a balancing process similar to that which the courts should undertake. They may accept enough federal intrusion into corporate affairs to restore value to their investment, but on the other hand desire enough board autonomy to permit uncompromised pursuit of profit.

139. From 1970 through 1977, 50,668 proxy solicitations for the election of directors were filed with the Commission. Elections were contested by shareholder groups in just 196 instances. In only 42 of the contests were nonmanagement nominees elected. These statistics are derived from the Annual Reports of the SEC. See, e.g., 43 SEC ANN. REP. 107 (1977). In 1978 the Commission ceased to include this data in its Annual Report.

140. 15 U.S.C. § 78(n) (1976).

141. See Carrington, *Pillero, Backer of Changes at the SEC, Is Controversial Contender for Top Post*, Wall St. J., Jan. 23, 1981, at 5, col. 1; Crock & Landauer, *Reagan Team Urges New Direction For SEC, Suggests Sporkin May Go*, Wall St. J., Jan. 22, 1981, at 27, col. 4; Gerth, *S.E.C.'s Future Focus in Doubt*, N.Y. Times, Jan. 29, 1981, § D, at D1, col. 3.

142. In 1980 the Commission instituted the fewest number of cases since 1969, secured the fewest number of injunctions since 1973, and had the fewest number of defendants enjoined since 1968. 46 SEC ANN. REP. 141 (1980); 43 SEC ANN. REP. 325 (1977). See Eisenberg, *SEC Injunctive Actions*, 14 REV. SEC. REG. 901, 901, 906 (1981); Kripke, *supra* note 75, at 194-95; Vilkin, *Fedders: New Look At the SEC*, Nat'l L. J., Jan. 25, 1982, at 3, col. 1, at 25, col. 1. Cf. Mathews, *supra* note 16, at 216-20 (SEC will likely increase its use of administrative proceedings, presumably decreasing its use of civil injunction).

laws.¹⁴³ In addition to the Court's concern that SEC power be kept within legal bounds, federal agency intrusion in general into areas of state law and free enterprise encounters opposition on philosophical grounds.¹⁴⁴ The director appointment remedy, when expanded beyond justifiable limits, thus is particularly vulnerable to attack.¹⁴⁵

A countervailing consideration is the need for a strong enforcement policy to curb various abuses in the securities industry.¹⁴⁶ Although corporations, out of either fear or reasoned acquiescence, have responded to the call for reform and accountability,¹⁴⁷ the SEC, and particularly its Enforcement Division, have actively pursued corporate misconduct and initiated productive remedial measures.¹⁴⁸

The question, then, becomes one of degree. Rather than have the director appointment remedy removed from its enforcement arsenal, the Commission should restore the remedy to the foundation upon which its justification is based. To facilitate this return and to rebut legitimate criticism, the Commission should re-evaluate and modify its use of the consent decree as a means to promote general policy.

A. *Re-evaluation of Litigation and Settlement as a Means for Policy Promotion*

Although use of a litigation and settlement process that results in appointment of independent directors is certain to have an impact on corporate governance,¹⁴⁹ the SEC should not view the process itself as a means to accomplish this goal.¹⁵⁰ When the Commission uses the overriding policy of a more independent board as an underlying justifica-

143. See, e.g., *Aaron v. SEC*, 446 U.S. 680 (1980); *Chiarella v. United States*, 445 U.S. 222 (1980); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

144. See, e.g., Farrel, *Corporations Are Already Overgoverned*, reprinted in COMMENTARIES, *supra* note 72, at 188.

145. See notes 117-40 *supra* and accompanying text. For a discussion of the legal limitations on a court issuing an injunction that includes the appointment of directors as ancillary relief, see notes 21-24 *supra* and accompanying text.

146. See, e.g., Carrington, *supra* note 141; *SEC Enforcer Blasts Proposals to Change Division, Cut Staff*, *Wall St. J.*, Jan. 26, 1981, at 1, col. 4.

147. See, e.g., Trowbridge, *supra* note 128, at 21-24.

148. See, e.g., Varner, *supra* note 137, at 23.

149. See Sommer, *supra* note 5, at 130.

150. See Loomis, *The SEC and Corporate Governance*, reprinted in COMMENTARIES, *supra* note 72, at 182, 185 ("[t]he concept of improvement of corporate governance by enforcement raises significant questions").

tion for the appointment of directors, the remedy loses its legal basis and becomes subject to criticism. In addition, other methods exist whereby the Commission can advance the policy of structuring a corporate board with directors who have no management affiliation.¹⁵¹ Furthermore, if the policy is to have a meaningful impact on corporate governance, voluntary adoption is preferable.¹⁵²

The trend toward greater independence of the board from management is a positive development in corporate governance. The Commission may illustrate the benefits derived from outside directors by pointing to cases of alleged securities law violations that were settled by consent with court approval.¹⁵³ This may prove as effective in deterring misconduct as it is in promoting independent boards. If, however, courts withdraw their support for the remedy, they will deprive the SEC of an effective method for resolving the supposed violation of securities laws.

B. *Elimination of Independent Special Counsel*

Requiring the appointment of a special counsel responsible to the Commission increases the likelihood of a charge that the SEC has intruded too far into internal corporate affairs.¹⁵⁴ The board of directors has the authority to engage a special agent or counsel and, theoretically, has the judgment to know when such action is appropriate.¹⁵⁵ Situations requiring particular expertise should result in the directors hiring a competent individual who will be responsible solely to them. When the Commission believes that outside directors will effectively

151. See notes 79-84 *supra* and accompanying text.

152. Voluntary action on the part of the corporate community has had a positive impact on governance reform. Trowbridge, *supra* note 128, at 21-24; Varner, *supra* note 137, at 24. The Commission itself looks to self-regulatory organizations as having "a vital role to play with respect to regulation of the trading market and their member firms. In addition . . . they can contribute significantly to the corporate accountability process." CORPORATE ACCOUNTABILITY, *supra* note 86, at 646. Additionally, voluntary attempts at reform and problem solving in general allow the Commission to function from a mode of guidance rather than one of enforcement.

153. Clinton Oil Co. is a good example. See notes 87-89 *supra* and accompanying text. The court's hope for viability has been realized. The company, now Energy Reserves Group, had net income of \$13.9 million in 1980. See 1981 MOODY'S OTC INDUSTRIAL MANUAL 1324.

154. Too often the counsel is akin to an agent of the Commission. Questions arise as to whether the counsel is aware of the obligation owed to the corporation and its shareholders and as to how he or she will respond when confronted with arguably proper, but conflicting, alternatives.

155. The Commission may want to be in a position to suggest this approach and even assist in locating a suitably trained and experienced individual. This person's authority, however, should stem from, and his or her accountability should be measured by, the company's board of directors.

address corporate improprieties, it should allow them to act unfettered by additional intervention.¹⁵⁶

C. *Expanded Use of Shareholder Initiative*

Whenever possible, SEC settlements should include provisions that allow shareholders to choose between alternatives¹⁵⁷ and vote on outside director nominations.¹⁵⁸ Not all cases permit this approach, particularly those that require the immediate performance of directorial duties.¹⁵⁹ The SEC could pursue and the courts should approve other plans that would, for example, summon a shareholder vote after a specified length of time or once the corporation has complied with the settlement terms.¹⁶⁰ The cases in which shareholders had the opportunity to exercise a preference demonstrate that the equitable relief can be creative. Expanded use of the shareholder vote also serves to placate those who would challenge the remedy on corporate democracy grounds.¹⁶¹

D. *Appointment of Directors With Qualifications Relevant to the Alleged Violation*

The most needed modification of the current SEC approach is the appointment of directors who have specific training or experience in

156. The inconsistency in appointing outside directors and then requiring a special counsel to do their work raises speculation that the Commission policy regarding director appointments is focused as much on board composition as on remedial action.

157. *See, e.g.*, SEC v. Basic Food Indus., Inc., 15 SEC DOCKET 133, 134 (Lit. Rel. No. 8440) (D.D.C. June 20, 1978) (public shareholders elect either a tender offer or cash merger); SEC v. Roussel, 10 SEC DOCKET 263, 264 (Lit. Rel. No. 7529) (E.D. La. Aug. 19, 1976) (shareholders may either rescind stock sale or receive differential to equal original tender offer price).

158. *See, e.g.*, SEC v. Invesco Int'l Corp., 12 SEC DOCKET 1369 (Lit. Rel. No. 8031) (N.D. Ga. July 19, 1977) (company to nominate, shareholders to elect enough unaffiliated directors to constitute a majority); SEC v. General Refractories Co., 10 SEC DOCKET 398 (Lit. Rel. No. 7544) (D.D.C. Sept. 1, 1976) (company to submit resolution to shareholder vote for approval of board increase by two independent directors).

159. *See, e.g.*, SEC v. First Mortgage Investors, 9 SEC DOCKET 856 (Lit. Rel. No. 7072) (S.D. Fla. Sept. 8, 1975) (new trustees appointed to form executive committee—chairman of executive committee to act as chief executive officer of company).

160. *See, e.g.*, SEC v. Marlene Indus. Corp., 17 SEC DOCKET 406 (Lit. Rel. No. 8733) (S.D.N.Y. Apr. 26, 1979) (company to nominate and recommend for election, for at least three years, a minimum of three independent directors). The *Marlene* settlement embodies an approach that allows courts to engage in the balancing process that should precede the issuance of a consent order. On the one hand, there is a need for independent oversight of corporate affairs; on the other hand, shareholders and the board retain important aspects of their traditional roles.

161. *See* notes 124 & 129-30 *supra* and accompanying text.

the area of the alleged violations. Qualified directors can more effectively address and remedy the allegations set out in the Commission's complaint. This factor should favorably affect the equitable balancing employed in the approval process.¹⁶² This arrangement is also more efficient for the corporation, because the accelerated compliance will cause less injury to shareholder interests.¹⁶³ Appointments that specifically outline the duties of the new directors in terms of their established talents encroach less upon the general management responsibilities of the elected directors.¹⁶⁴ Additionally, these guidelines will permit the SEC to be less involved in the selection process, further reducing the tension with state law and shareholder democracy.¹⁶⁵

IV. SEC PRECEDENT IN SELECTION OF SPECIALLY QUALIFIED DIRECTORS BY A CORPORATE DEFENDANT

Two recent settlements illustrate the willingness of the Commission to modify its previously dominant role in the consent process. *In re Occidental Petroleum Corp.*,¹⁶⁶ an administrative proceeding brought to determine whether Occidental (Oxy) failed to disclose certain environmental matters that could have had a substantial impact on its financial condition, was settled by an offer from Oxy to which the SEC consented.¹⁶⁷ Oxy undertook the appointment of a new director who was satisfactory to the Commission and who had delineated responsibilities specifically addressing the issues raised by the investigation.¹⁶⁸ The

162. An individual trained in a particular area will be better able to remedy the existing problem and develop policies for future avoidance so that appointed entry into the corporate structure is less offensive.

163. In this sense, shareholders may be eager to forego the electoral process, provided that a check on undue infringement of their rights is built into the system.

164. The authority delegated to the board by the shareholders is one of general management. An appointed director with specifically outlined duties creates less of a barrier to the flow of internal corporate power.

165. One of the conceptual difficulties with court-appointed corporate officials approved by the SEC is the leverage exercised by the Commission in the consent process. See note 63 *supra*. In appointing an official independently qualified to address the particular charge, the court addresses the corporation's needs more than the Commission's wants.

166. Securities Exch. Act Rel. No. 16950, 20 SEC DOCKET 567 (July 2, 1980).

167. *Id.* at 576-77.

168. *Id.* at 576. The new director would be responsible for reporting to the full board and recommending procedures to ensure the disclosure of environmental matters in accordance with the securities laws and to amend reports currently on file. *Id.* Potential costs of compliance with other federal and state laws, maximum civil penalties, and the amount of alleged third party

Commission's access to the director was limited to a manner agreed upon with Oxy.¹⁶⁹

The elements of the *Occidental Petroleum* settlement are preferable to the type of orders previously obtained by the SEC for three reasons. First, responsibility for correcting and preventing incomplete disclosure rested entirely with the existing board of directors.¹⁷⁰ Second, the board's search for and appointment of the new director was more consistent with the requirements of state law.¹⁷¹ Finally, because the only emphasis of the settlement was upon informing and advising the board, effectuation of congressional purpose did not become subservient to the pursuit of any other policy.¹⁷²

In *SEC v. Tesoro Petroleum Corp.*¹⁷³ the complaint alleged misappropriation of corporate funds in connection with foreign business.¹⁷⁴ Tesoro consented to nominate and recommend for election by shareholders a new director satisfactory to the Commission.¹⁷⁵ The new director was to serve only a three-year term.¹⁷⁶ He or she was also to become chairman of Tesoro's Audit Committee and coordinate efforts to formulate and implement policies designed to prevent occurrence of matters such as those alleged in the complaint and to oversee future foreign transactions.¹⁷⁷

In the *Occidental Petroleum* and *Tesoro* settlements, control over questionable corporate conduct remained within the corporate structure. The SEC, however, did not pursue its compliance policies with any less vigor than usual. *Occidental Petroleum* and *Tesoro* demonstrate that federal agencies can hold corporations to high standards of

claims were to be determined and fully reported to the board and the Commission. *Id.* The director, with assistance from Oxy's newly elected senior environmental official and an independent consulting firm, was also to describe legal, interpretative, or technological problems in which he was unable to formulate any recommendations. *Id.* Finally, Oxy indicated a policy of full cooperation by permitting the new director, at his discretion, to review company documents and interview employees and by authorizing him to retain experts reasonably necessary in the completion of his duties. *Id.* at 576-77.

169. *Id.* at 576.

170. The power delegated to the board by the shareholders thus remained within its proper boundaries.

171. See note 126 *supra*.

172. See notes 87-99 *supra* and accompanying text.

173. 21 SEC DOCKET 679 (Lit. Rel. No. 9236) (D.D.C. Nov. 20, 1980).

174. *Id.* at 680.

175. *Id.*

176. *Id.*

177. *Id.*

accountability without sacrificing the qualities of independence that are cornerstones of the free enterprise system. The SEC should not dilute its enforcement efforts, but instead should modify its use of the director appointment remedy to utilize the principles underlying state law and corporate democracy. More particularly, by seeking election of individuals specifically qualified to address the corporation's problems, the Commission can use its expertise less as a vehicle for dominance and more for the purpose of guidance.¹⁷⁸

V. CONCLUSION

The court appointment of directors, developed by the SEC in response to securities law violations, has proven effective as an ancillary remedy. Properly employed, the remedy can serve to protect the investing public's interests by offering remediation of past infractions and serving as a deterrent to future misconduct.

The SEC, however, has extended the remedy beyond the limits justified by equitable considerations.¹⁷⁹ As a new era of federal regulatory power is anticipated,¹⁸⁰ the Commission should modify its approach to comport more with the equity principles upon which the remedy rests.¹⁸¹ By withdrawing those features subject to well-founded objections¹⁸² and by specifically outlining the qualifications and duties of¹⁸³ those individuals who are to become the directors, the Commission can implement this modification. By adopting a modified approach, the Commission can supplement its policing function with a quality of guidance available only from an experienced regulatory agency.

Congress will not likely amend the securities laws to authorize the court appointment of directors.¹⁸⁴ The remedy therefore will remain

178. The Commission may thus be able to recognize the progress made through voluntary adoption of well-reasoned approaches to corporate reform.

179. See notes 18-24 *supra* and accompanying text.

180. See notes 141-42 *supra* and accompanying text. Other regulatory agencies may find the remedy useful when properly employed. Often their own enforcement mechanisms are either ineffective or counterproductive. Monetary fines, levied in amounts large enough to evoke corporate response, serve to diminish the company's net worth. This in turn harms the shareholder public, which is the object of the protective legislation in the first place. For an article outlining some difficulties with regulatory compliance, see *Court Created Receiverships Emerging As Remedy for Persistent Non-Compliance with Environmental Laws*, 10 ENV'T'L L. REP. 10059 (1980).

181. See notes 18-24 *supra* and accompanying text.

182. See notes 149-56 *supra* and accompanying text.

183. See notes 162-78 *supra* and accompanying text.

184. *But see* Wolfson, *supra* note 8. Professor Wolfson advocates legislation that will permit

part of the equitable relief that federal courts are empowered to fashion.¹⁸⁵ The ultimate responsibility for checking SEC abuse of the remedy thus lies with the judiciary. Courts should not hesitate to disapprove terms that fail to balance the competing interests equitably, even when the settlements are entered with the consent of the corporate defendant. The SEC, on the other hand, should not hesitate to employ the director appointment remedy when it can tailor the settlement terms to specifically address the alleged impropriety.

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court-appointed directors only in exceptional situations, that is, after certain criteria have been met. Once activated, the provisions allowing for appointment should require outlining of duties and responsibilities. *Id.* at 24. The Proposed Federal Securities Code does not change the current state of the law in this area. *See* ALI FED. SEC. CODE § 1819(1) (court has authority to grant appropriate ancillary and other relief) (Proposed Official Draft 1978); *id.* § 1904(i) (nothing in Code affects application of state law pertaining to appointment of directors).

185. The concept that gives rise to this power anticipates judicial scrutiny. Only when the particular facts are analyzed in terms of the proposed settlement can the case be fairly adjudicated.