January 1982

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Recommended Citation
Stephen C. Jones, SEC and Court-Appointed Directors: Time to Tailor the Director to Fit the Suit, 60 Wash. U. L. Q. 507 (1982).
Available at: http://openscholarship.wustl.edu/law_lawreview/vol60/iss2/9

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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 relief 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 directors 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. 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.  

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. The Securities Act of 1933 and the Securities Exchange Act of 1934 empower the Commission to bring suits for infractions in the federal district courts 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. 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.


pressly authorizes court appointment of directors. 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. Use of the consent decree process encounters little judicial resistance and is attractive to both the Commission and the defendant corporations. 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.

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. Because standards governing the issuance of statutory injunctions are broad, federal courts are guided more by legislative objectives and public interest than by the showing of irreparable


8. See Farrand, supra note 2, at 1781; Malley, supra note 2, at 58; Wolfson, From the Board-room—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.


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

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

\textsuperscript{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).
\textsuperscript{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'd, 306 F.2d 606 (2d Cir. 1962) (en bane). 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).
\textsuperscript{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.
\textsuperscript{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(i), 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.
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, and it may not surpass its remedial function by conveying punitive implication. The SEC, as plaintiff, must demonstrate a clear need for the relief requested. In addition, the courts must balance the harm to competing interests against the benefits to be derived from the proposed resolution.

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

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 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.


24. See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970); DiGiovanni v. Camden Fire Ins. Ass'n, 296 U.S. 678 (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. 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.

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 appointees to a majority of independent directors for the reconstituted board, with a few demanding an entirely new group of individuals. Some decrees outline responsibilities for the new board.

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.
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. Roussell, 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. 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. In addition, the defendant frequently agrees to the appointment of a special counsel who has investigatory and reporting responsibilities independent from the new board.

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. The less the settlement terms relate to the alleged violations, however, the greater the punitive implications. 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.

(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).


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 benefited 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, while the other requires Commission approval of every new director. 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.

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. Although the bluntness of SEC intrusion into internal corporate affairs is thus cushioned, courts nonetheless should closely scrutinize the arrangement. 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.

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 majority or an entirety of the committee membership.

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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.


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.


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

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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.


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. 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. 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. Second, the adverse publicity of trial proceedings is undesirable. 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. These practical considerations operate to force the consent decree process upon corporations unless the Commission's claims are completely groundless.

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

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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.
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. Beyond these administrative concerns, the corporation's consent will subject the terms desired by the SEC to less judicial scrutiny.

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. Although consent by the corporation is often a prudent alternative, this settlement mechanism still carries with it profound implications.

II. SEC USE OF THE REMEDY

Although the Commission has not attempted to develop standards for using the director appointment remedy, it nonetheless has enthusiastically adopted the concept. 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 Freights, 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, 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 Ruckelshaus, 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...
corporate misconduct and the Commission's consequent determination to take an active role in corporate governance, 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. 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. The Commission responded by implementing its management fraud program, which marked the beginning of a period during which the SEC became more involved and influential in internal corporate affairs.

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 restless 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. 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. Instead, the SEC employed less official methods to convey its attitude.

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. The Exchange later adopted this concept.

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

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].


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. Lack of an articulated standard and inconsistent application of the remedy 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. 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. Congress did not intend, except in the Investment Advisor's Act of 1940, 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.

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).


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. "The 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. 3870.
The consent decree process, interpreted to have special sanctuary from judicial review,\(^7\) 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.\(^8\) When lifted from its legal foundation, however, the remedy cannot withstand close scrutiny.\(^9\)

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

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\(^{97}\) 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.


\(^{101}\) 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).
Two cases, however, have sustained the validity of intrusion into corporate affairs when consented to by the defendant. Both SEC v. Handler\footnote{Block & Barton, supra note 102, at 49 n.31; Sommer, supra note 5, at 129.} and International Controls Corp. v. Vesco\footnote{610 F.2d 656 (9th Cir. 1979).} 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,\footnote{490 F.2d 1334 (2d Cir.), cert. denied, 417 U.S. 932 (1974).} themselves serving by the terms of a consent decree.\footnote{610 F.2d at 657.} The complaint alleged a violation of article III of the Constitution in that the SEC delegated governmental power to a private person.\footnote{610 F.2d at 658-59.} Holding that a district court is "inherently invested with broad equitable powers . . . [i]n order to give effect to remedial statutes,"\footnote{Id. at 659.} the Ninth Circuit affirmed dismissal of the suit.\footnote{Id. at 660.} Significantly, the court viewed the appointment of special counsel by consent as a "self-initiated corporate investigation."\footnote{Id. at 1352.}

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.\footnote{International Controls Corp. v. Vesco, 490 F.2d 1334, 1338-40 (2d Cir.), cert. denied, 417 U.S. 932 (1974).} The former controlling shareholder challenged this settlement in state court,\footnote{Id. at 1352.} claiming that the previous directors abdicated their responsibility by accepting these terms.\footnote{Id.} The special counsel obtained a federal court injunction against prosecution of the state actions,\footnote{Id.} and the Second Circuit affirmed those provisions of the
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

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


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.


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" and concluded that "except in the most egregious cases, courts should not interfere with corporate democracy."

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. 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. The case for federal chartering of corporations, often sponsored by consent decree that affects 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

http://openscholarship.wustl.edu/law_lawreview/vol60/iss2/9
with staunch support,\textsuperscript{127} has failed to receive the congressional backing necessary for its adoption.\textsuperscript{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 laws\textsuperscript{129} and espoused by the SEC.\textsuperscript{130} In this sense, a fundamental conflict exists in the justification for the remedy: it tends to effectuate one legislative purpose while ig-

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\textsuperscript{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, \textit{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, \textit{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. \textit{Id.} at 93; Note, \textit{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, \textit{supra} note 5, at 118. Congress, however, rejected the proposals and instead focused on disclosure as a regulatory mechanism. \textit{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. Metzenbaum). For an article outlining the key features of the two bills, see Trowbridge, \textit{Congress and Corporate Governance}, Corp. Dir., Sept./Oct. 1980, at 21.


noring another distinct goal of the same legislation.\textsuperscript{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.\textsuperscript{132} In the pursuit of federal objectives, however, federal actions must not unduly interfere with legitimate state interests.\textsuperscript{133} In \textit{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.\textsuperscript{134} The \textit{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.\textsuperscript{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,\textsuperscript{136} there is little doubt that concern for the corporation's economic performance is their paramount consideration.\textsuperscript{137} Complete usurpation of the right to

\textsuperscript{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.


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

\textsuperscript{134} 441 U.S. 471, 480, 486 (1979). In \textit{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 \textit{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 \textit{Borak} that requires close scrutiny of the particular fact pattern.

\textsuperscript{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.

\textsuperscript{136} See \textit{CORPORATE ACCOUNTABILITY}, supra note 86, at 66.

\textsuperscript{137} See id. See generally Coffee, supra note 63, at 1259; Soderquist & Vecchio, \textit{Reconciling...
elect directors would prompt shareholder displeasure, but less resent-
ment and perhaps even approval may result if court-appointed direc-
tors assist in preserving or restoring a corporation's financial health.

Coupled with this analysis is the recognition that shareholder suf-
frage has not been an effective means for either preventing corporate
wrongdoing or removing misfeasant management. The proxy rules
promulgated under section 14 of the Securities Exchange Act 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 congress-
sional 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 retrench-
ment in the 1980s have become reality. The process began with
Supreme Court limitations on the reach of the federal securities

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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 re-
store 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.


laws. 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. The director appointment remedy, when expanded beyond justifiable limits, thus is particularly vulnerable to attack.

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

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, the SEC should not view the process itself as a means to accomplish this goal. When the Commission uses the overriding policy of a more independent board as an underlying justifica-


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.


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. Furthermore, if the policy is to have a meaningful impact on corporate governance, voluntary adoption is preferable.

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. 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. 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. 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.


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. This arrangement is also more efficient for the corporation, because the accelerated compliance will cause less injury to shareholder interests. 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. 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.

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., 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. 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. The

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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.


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. 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. Second, the board's search for and appointment of the new director was more consistent with the requirements of state law. 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.

In SEC v. Tesoro Petroleum Corp. the complaint alleged misappropriation of corporate funds in connection with foreign business. Tesoro consented to nominate and recommend for election by shareholders a new director satisfactory to the Commission. The new director was to serve only a three-year term. 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.

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. 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. 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. 

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.
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 152-78 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. 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.