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THE USE OF THE CORPORATE MONITOR IN SEC ENFORCEMENT ACTIONS

*Jennifer O'Hare**

I. INTRODUCTION

It's an unusual role where you have veto power over the audit-committee chairman and over the CEO.¹

Statement of WorldCom's Corporate Monitor

The WorldCom² securities fraud led to numerous lawsuits, several criminal convictions, and the Sarbanes-Oxley Act of 2002 (SOX). It also led to a novel Securities and Exchange Commission (SEC) remedy, which significantly increases the enforcement power of the SEC. In the WorldCom enforcement action, the SEC sought, and obtained, the judicial appointment of a "Corporate Monitor." About two years later, when the Corporate Monitor's work was done, he had caused the company to overhaul its corporate governance completely and to adopt several unique governance provisions. He had also exercised oversight over all major business decisions, including the sale of the company to Verizon. Put simply, his primary responsibility was to ensure that the company would not commit securities fraud ever again.

The Corporate Monitor is something new in corporate and securities law and it represents the latest example of the SEC seeking to shift its enforcement responsibilities to the public companies it regulates.³ This

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1. See Joann S. Lublin & Shawn Young, *Even as MCI Makes Strides, Monitor Stays*, WALL ST. J., Apr. 20, 2004, at B1.

2. Following the scandal, WorldCom was renamed MCI, Inc. and was eventually acquired by Verizon, Inc. See, e.g., *Out of Chapter 11, WorldCom is Again MCI*, N.Y. TIMES, Apr. 21, 2004, at C13; Stephen Labaton, *Judge Looks Into Modifying Terms of 2 Phone Mergers*, N.Y. TIMES, July 8, 2006, at C3. For ease of reference, this article refers to the company by its original name, WorldCom.

3. The SEC has sought the Corporate Monitor remedy in several other cases. See, e.g., SEC v. Spear & Jackson, Inc., Litigation Release No. 18668, 82 SEC Docket 2464 (Apr. 16, 2004) (seeking a Corporate Monitor "to oversee" the company's affairs); SEC v. Hollinger Int'l, Inc., Litigation Release No. 18550, 81 SEC Docket 3593 (Jan. 21, 2004) (seeking a Special Monitor "to protect the interests of Hollinger International shareholders"); SEC v. U.S. Technologies, Inc., Litigation Release No. 18031, 79 SEC Docket 2340 (Mar. 12, 2003) (seeking the appointment of a Corporate Monitor "to review and approve [the company's] future disbursements and corporate actions"). In addition, the SEC has recently indicated that it might seek a Corporate Monitor in a potential action against DHB Industries, Inc. See Press Release, DHB Industries, Inc. Reports Receipt of "Wells Notice" From the Securities and Exchange Commission, DHB Indus., Inc., Form 8-K (May 25, 2006), available at <http://www.secinfo.com/d11Amt.vcb.d.htm#1stPage>

article explores this method of SEC outsourcing. Part II briefly discusses the SEC's enforcement powers, including the use of ancillary relief in judicial enforcement actions. Part III reviews the role of WorldCom's Corporate Monitor, beginning with his initial appointment and tracing the evolution of his authority at the company. In particular, this paper explores both the corporate governance changes that were imposed by the Corporate Monitor and his extended oversight of the company.

Part IV considers some of the dangers of the SEC's use of the Corporate Monitor in its enforcement actions, such as the potential of a de facto expansion of the Corporate Monitor's power beyond the authority defined in the court orders and the danger that a Corporate Monitor with far-reaching powers will interfere with the ability of a board and corporate officers to manage the company effectively. The appointment of a Corporate Monitor, accountable only to the court, raises interesting issues of corporate law. This article analyzes whether the use of a Corporate Monitor conflicts with state corporate law and whether the appointment of the Corporate Monitor constitutes impermissible overreaching by the SEC. Part V concludes by recommending that the SEC seek an appointment of a Corporate Monitor only in very rare cases and publish guidance explaining when it will seek this ancillary remedy. Similarly, courts should articulate clear judicial standards that must be met before granting this extraordinary remedy. The final recommendation is a suggested judicial standard under which a court should appoint a Corporate Monitor only if the danger that a company will not comply with a court order to obey the federal securities laws outweighs the significant dangers associated with the use of a Corporate Monitor.

II. SEC ENFORCEMENT PROCEEDINGS AND ANCILLARY REMEDIES

A. SEC ENFORCEMENT PROCEEDINGS

Section 21(d) of the Securities Exchange Act of 1934 ('34 Act) empowers the SEC to seek injunctive relief in federal district court whenever it appears that "any person is engaged or is about to engage in acts or practices constituting a violation" of the federal securities laws.⁴ To obtain the injunction, the SEC must show that there is a "reasonable

(disclosing that the SEC had notified the company that it was considering instituting an enforcement action). Corporate Monitors have also been sought in criminal cases, especially through deferred prosecution agreements. *See, e.g.,* David A. Vise, *AOL Settlement Includes Tight Controls*, WASH. POST, Dec. 17, 2004, at E5 (noting that AOL agreed to hire a Corporate Monitor).

4. Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u(d) (Supp. II 2002). For a good discussion of the SEC's use of the injunction, see Daniel J. Morrissey, *SEC Injunctions*, 68 TENN. L. REV. 427 (2001).

likelihood” of future violations of the federal securities laws.⁵ When a court issues the injunction, it is required to provide a brief explanation of the reasons underlying the order.⁶

In addition to an injunction, the SEC is also expressly empowered to seek other remedies including monetary penalties,⁷ orders barring individuals from serving as officers and directors of public corporations,⁸ and other equitable relief,⁹ such as ancillary remedies.¹⁰

B. CONSENT DECREES AND SETTLEMENTS

Approximately 90% of SEC enforcement actions are settled. The SEC often files the complaint and the settlement simultaneously in federal court.¹¹ The court is then asked to approve the settlement as a consent decree.¹²

The incentives for each party to settle are obvious. For the resource-strapped SEC, settlement is often preferable to a costly trial. For the defendant, settlement offers a variety of advantages.¹³ It is often cheaper for a defendant to settle than to go forward with a contested case. Settlements also limit bad publicity, especially because the SEC does not require the defendant to admit to any wrongdoing. In addition, a defendant may feel incredible pressure from the SEC to settle and, if the defendant refuses to settle, the SEC may claim of lack of cooperation, which could impact the sanctions the SEC decides to seek if the case is contested. Finally, the

5. See MARC I. STEINBERG & RALPH C. FERRARA, 25 SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 5:5 (2006) (“[T]he test applied in practically all federal courts is whether there is a reasonable likelihood that the defendant, if not enjoined, will again engage in the violative conduct.”).

6. The Federal Rules of Civil Procedure provide that:

Every order granting an injunction . . . shall set forth the reasons for its issuance; shall be specific in terms; shall describe in reasonable detail . . . the act or acts sought to be restrained; and is binding only upon the parties to the action

FED. R. CIV. P. 65(d).

7. See Securities Exchange Act of 1934 § 21(d)(3), 15 U.S.C. § 78u(d)(3) (Supp. II 2002) (imposing a three-tiered penalty scheme with penalties ranging from \$50,000 to \$500,000 for corporations).

8. See *id.* § 78u(d)(2) (stating that the court may prohibit any person from serving as officer or director “if the person’s conduct demonstrates unfitness to serve as an officer or director”).

9. See *id.* § 78u(d)(5) (“[A]ny Federal court may grant[] any equitable relief that may be appropriate or necessary for the benefit of investors.”).

10. See *infra* Part II.C.

11. See STEINBERG & FERRARA, *supra* note 5, § 3:60.

12. Here, the term “consent decree” is used to mean a court-approved settlement between the defendant and the SEC. As one noted commentator has stated, a consent decree is “an agreement between the parties to end a lawsuit on mutually acceptable terms which the judge agrees to enforce as a judgment.” Larry Kramer, *Consent Decrees and the Rights of Third Parties*, 87 MICH. L. REV. 321, 325 (1988).

13. See THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 183–85 (Richard M. Phillips ed., 1997).

defendant may decide to settle to avoid the potential collateral estoppel effects resulting from a successful SEC injunctive action. All in all, even innocent defendants have good reasons to agree to a settlement.

Although the parties to a consent decree have by definition agreed to the injunctive relief, the court does not automatically approve the settlement. Because an SEC consent decree has the potential to impact the rights of third parties, the district court conducts a limited review of the agreement's fairness. The standard set forth in most cases is that the court will approve the consent decree unless it is "unfair, inadequate, or unreasonable."¹⁴ In making this determination, the court gives substantial deference to the administrative agency's decision to settle the case. The limited nature of the review is understandable given the strong federal policy favoring approval of consent decrees.¹⁵ Moreover, because of the non-adversarial nature of the settlement process, a court would have difficulty receiving information tending to show that a settlement is unfair. Not surprisingly, courts approve most SEC consent decrees.

C. ANCILLARY RELIEF

In addition to seeking injunctions, the SEC commonly seeks "ancillary relief" to enforce the federal securities laws. The term "ancillary relief" refers to non-statutorily based remedies that supplement an injunction. Implicit in the ancillary remedy is the assumption that an order enjoining the defendant from future violations of federal securities laws will not be effective, so that more direction is needed from the court to ensure that the defendant will comply with the federal securities laws.

One commentator observed three different categories of ancillary relief: (1) remedies intended to correct *past* violations of the federal securities laws, such as disgorgement; (2) remedies intended to preserve the existing condition of the defendant during the pendency of the action, such as an asset freeze or the appointment of a receiver; and (3) remedies intended to discourage *future* violations of the federal securities laws by regulating certain aspects of the defendant's future behavior, such as the institution of corporate governance changes, the judicial appointment of board members, or the appointment of special investigative agents.¹⁶

This third type of ancillary relief has been the subject of a robust academic debate that began in the 1960s and 1970s when the SEC first

14. See, e.g., *SEC v. Randolph*, 736 F.2d 525, 529 (9th Cir. 1984) ("Unless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved.").

15. See, e.g., *SEC v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991) ("[There is] already a strong federal policy favoring the approval and enforcement of consent decrees.").

16. See George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 869-72 (1983).

started to aggressively seek these remedies.¹⁷ Commentators have argued that the corporate governance reforms required by the SEC in its consent decrees can interfere with the effective management of a company.¹⁸ Similarly, court appointment of SEC-approved directors can be a significant intrusion on shareholder suffrage, while the appointment of special investigative agents can undermine attorney-client privilege.¹⁹ And, finally, because it is doubtful that the SEC has authority to promulgate rules with the same far-reaching effect as the ancillary remedies ordered by a court, the judicial grant of ancillary relief presents a real danger of SEC overreaching.²⁰

Despite these criticisms, the SEC has sought, and has usually obtained, ancillary relief from the courts.²¹ The courts have easily found the authority to order these remedies.²² Historically, courts have relied on their inherent equitable powers—as opposed to a grant of power under the federal securities laws—as the basis for ordering ancillary relief.²³ Courts have reasoned that “[o]nce the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy.”²⁴

Although the courts in the past looked to their broad equitable powers to grant ancillary relief, courts now have statutory power to grant these remedies in SEC enforcement actions. As part of SOX, the ‘34 Act was amended to authorize the granting of “any equitable relief that may be appropriate or necessary for the benefit of investors.”²⁵ In enacting this provision, Congress signaled its approval of the use of ancillary relief in SEC enforcement actions.²⁶

17. For a good discussion of the history of the SEC’s use of ancillary relief, see Morrissey, *supra* note 4, at 443–47.

18. See, e.g., James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1805 (1975–1976) (“[Ancillary relief has] provided a means for governmental control of corporate management and decision-making . . .”).

19. See, e.g., Arthur F. Mathews, *Recent Trends in SEC Requested Ancillary Relief in SEC Injunctive Actions*, 31 BUS. LAW. 1323, 1328–30 (1975–1976) (discussing the attorney-client privilege).

20. See *infra* Part IV.E.

21. See Morrissey, *supra* note 4, at 447 (“By the late 1970s, ancillary relief had become a well-accepted expansion of the Commission’s authority.”).

22. As one commentator noted, “The most persuasive argument for ancillary relief in federal securities law is that the Supreme Court and many lower courts have approved such relief and that almost no judicial precedent has questioned it.” See Dent, *supra* note 16, at 869.

23. See Committee on Federal Regulation of Securities, *Report of the Task Force on SEC Settlements*, 47 BUS. LAW. 1083, 1116 (1992).

24. SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1103 (2d Cir. 1972).

25. Securities Exchange Act of 1934 § 21(d)(5), 15 U.S.C. § 78u(d)(5) (Supp. II 2002).

26. A review of the legislative history revealed only one reference to the grant of the expanded equitable powers, in a discussion relating to disgorgement. The Senate Report states that:

The Commission has also suggested that it should be allowed to obtain additional relief in enforcement cases. For a securities law violation, currently an individual may be ordered to disgorge funds that he or she received “as a result of the violation.” Rather

III. WORLDCOM AND THE CORPORATE MONITOR

WorldCom perpetrated one of the most massive accounting frauds in United States history. Over a period of several years, WorldCom managers improperly inflated the company's income by over \$9 billion. After WorldCom announced that it would be restating its financial results, the SEC brought an enforcement action against the company contending that it violated the anti-fraud provisions of the federal securities laws. In the complaint, the SEC sought an injunction against further violations and sought monetary penalties. The complaint also sought fairly typical ancillary relief, such as orders prohibiting the company from destroying any documents and from making any extraordinary payments to WorldCom employees. In addition, the SEC asked the court to appoint a so-called "Corporate Monitor."

A. THE EVOLVING JUDICIAL AUTHORITY OF THE CORPORATE MONITOR

1. The Initial Appointment of the Corporate Monitor

On June 26, 2002, the SEC filed its initial complaint, asking the district court to appoint a Corporate Monitor to "ensure compliance" with any court orders prohibiting the destruction of evidence or the paying of excessive compensation.²⁷ Two days later, pursuant to a stipulation between the SEC

than limiting disgorgement to these gains, the bill will permit courts to impose any equitable relief necessary or appropriate to protect, and mitigate harm to, investors.

S. REP. NO. 107-205, Title III(E) (2002).

27. Specifically, the SEC requested the following relief from the court:

- A. Permanently restraining and enjoining WorldCom from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;
- B. Permanently restraining and enjoining WorldCom from violating Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-3 thereunder;
- C. Imposing civil monetary penalties on WorldCom pursuant to Section 21(d) of the Exchange Act [15 U.S.C. § 78u];
- D. Prohibiting WorldCom and its affiliates, officers, directors, employees, and agents, from destroying, altering, or removing from the court's jurisdiction any documents relevant to the matters alleged herein;
- E. Prohibiting WorldCom and its affiliates from making any extraordinary payments to any present or former affiliate, or officer, director, or employee of WorldCom, or its affiliates, including but not limited to any severance payments, bonus payments, or indemnification payments;
- F. Appointing a corporate monitor to ensure compliance with Items D and E, above; and
- G. Granting such other and additional relief as this Court may deem just and proper.

and WorldCom, Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York ordered the appointment of a Corporate Monitor. The court did not immediately select the Corporate Monitor, but instead directed the parties to jointly propose a name to the court within five days.²⁸

On July 3, 2002, the court appointed Richard C. Breeden, a former Chairman of the SEC, to act as WorldCom's Corporate Monitor.²⁹ Although the appointment was not accompanied by a written description of the selection process, a transcript from the hearing indicates that Judge Rakoff selected Mr. Breeden from a list of three names pre-approved by both the SEC and WorldCom.³⁰

2. The Initial Authority of the Corporate Monitor

Initially, the WorldCom Corporate Monitor had fairly limited authority. He had two main charges: prevent the destruction of evidence³¹ and prevent the payment of excessive executive compensation.³² The court was concerned that, without court oversight, WorldCom managers would

Complaint at 4, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. June 26, 2002). The SEC's amended complaint is substantially similar. See First Amended Complaint at 10, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. Nov. 5, 2002).

28. See Stipulation and Order at 3, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. June 28, 2002) [hereinafter WorldCom June 28 Stipulation and Order]. According to the order, if the parties failed to agree by July 3, 2002, the court would schedule a conference to select the Corporate Monitor. *Id.* at 4.

29. See Memo to Civil Docket Clerk, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 3, 2002).

30. See Transcript of Record at 2, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 3, 2002) [hereinafter WorldCom Transcript of Record]. The names of the other two candidates were not disclosed during the hearing. See *id.*

31. See WorldCom June 28 Stipulation and Order, *supra* note 28, at 2. Pursuant to the court order, "the Corporate Monitor shall confirm that WorldCom has implemented reasonable document retention policies and the Corporate Monitor shall take reasonable steps to oversee compliance with those policies." *Id.* at 3.

32. *Id.* at 2. The applicable portion of the court order reads in its entirety:

Upon appointment by the Court pursuant to this Order, the Corporate Monitor for WorldCom shall have oversight responsibility with respect to all compensation paid by WorldCom. The intent of the parties is that the Corporate Monitor shall exercise its oversight responsibility to prevent unjust enrichment as a result of the conduct alleged in the Complaint and to ensure that the assets of WorldCom are not dissipated by payments that are not necessary to the operation of its business. For purposes of this Stipulation and Order, compensation is defined so as to include salary, as well as any severance payment, bonus, indemnification, gift, loan, reimbursement, advance, or consideration of any kind in excess of established salary, but does not include payments to reimburse employees for ordinary business expenses incurred. In exercising its oversight responsibility, the Corporate Monitor shall have discretion to determine the type of compensation to review and either approve or disapprove, as well as the discretion to determine the group of officers, directors and employees with respect to which such compensation shall be reviewed and either approved or disapproved.

Id.

continue to receive the excessive salaries and perks that had been the norm at the Bernie Ebbers-run company. Thus, the Corporate Monitor was expressly authorized to either approve or disapprove all compensation payments made by WorldCom.³³

3. The Expanding Judicial Authority of the Corporate Monitor

Although the Corporate Monitor's role began as a way to ensure that WorldCom did not continue its widely-reported practice of paying excessive compensation to its current (and former) managers, Mr. Breeden's authority quickly began to expand.³⁴ First, very early in the proceedings, the court issued an order significantly expanding the definition of "compensation." According to the court, compensation included not only payments made to WorldCom executives, but also payments made to any "outside advisor" hired by WorldCom.³⁵ For example, the Corporate Monitor was given oversight and approval authority over payments made to WorldCom's investment bank, restructuring advisors, and attorneys.

Shortly after WorldCom's bankruptcy filing, Judge Rakoff reiterated the breadth of the Corporate Monitor's authority. He stated, "[t]o put it bluntly, it is the responsibility of the Corporate Monitor, among other responsibilities, to prevent unnecessary compensatory expenditures by the company, not only in the form of looting by miscreants but also in the form

33. The order provides that the Corporate Monitor has the discretion to "approve or disapprove" compensation payments. *Id.* at 2. It also states that if the Corporate Monitor does not promptly approve a compensation payment, WorldCom could seek approval from the court. *Id.* at 3.

34. Interestingly enough, the expansion of the Corporate Monitor's role appears to have been contemplated by the court from the beginning. During the hearing at which Mr. Breeden was appointed as WorldCom's Corporate Monitor, Judge Rakoff stated that:

[I]t may be . . . that he will have other functions to serve as time goes on. We don't need to reach that today, because this will be a fluid situation that will evolve with the great assistance of both sides, and if and when it is necessary to have any discussions about the appropriateness of broadening the monitor's role, we will, of course, have a public discussion here in court.

WorldCom Transcript of Record, *supra* note 30, at 4.

35. As the court stated:

Lest there be any doubt as to the scope of [the Corporate Monitor's] access, it means, among much else, that "outside advisors" hired, retained, or consulted by the defendant or by any of its officers, directors, agents, or employees, or anyone acting in concert with any of them, to help advise the company or its board in the current circumstances must, upon pain of contempt, make full disclosure to the Corporate Monitor of any and all information the Corporate Monitor requests (including, by way of example, their own compensation arrangements with the defendant and their advice to the defendant or its Board). Among others, such advisors include, by way of example, investment banking advisors like Goldman Sachs & Co. and outside investigators like Wilmer, Cutler & Pickering.

Order at 1–2, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 15, 2002).

of excessive compensation of those who mistake a damaged company for a broken piggybank.”³⁶

To determine what was “necessary” to WorldCom’s operations, the court determined that the Corporate Monitor should receive information well beyond simple compensation arrangements. According to the court, Mr. Breeden was entitled to receive “complete information about every aspect of the business he deems relevant to his assessments” in advance of any company action.³⁷ In addition, the order specifically stated that the

36. Memorandum Order at 3, SEC v. WorldCom, Inc., 2002 U.S. Dist. LEXIS 14201, at *4 (S.D.N.Y. Aug. 1, 2002) (No. 02 Civ. 4963).

37. *See id.* Specifically, the order provided that the Corporate Monitor be provided with the following information:

- a. any document or information communicated by the company or any professional employed by the company to any of (i) the official committees, (ii) any debtor-in-possession (“DIP”) lender, (iii) any participant in the bank group or (iv) any other creditor (any such person being a “Covered Party”). This includes, *inter alia*, financial or other reports, projections, analyses, proposals, covenant tests, or other written (including electronic format) material.
- b. any financial or other report, study, projection, analysis, proposal, presentation or other document relating in any way to material business decisions or the conduct of the bankruptcy (including any such item labeled “drafts” but nonetheless circulated) generated by any professional employed by the company and communicated to senior management of the company. This includes, *inter alia*, financial reports, restructuring proposals, downsizing analyses, disposition alternatives, “RIF” proposals and proposals to, or under discussion with, potential acquirors, lenders or investors.
- c. any plan, proposal or study, including conceptual issue reviews, relating to compensation in any form, including severance and retention programs of any kind, and including, without limitations, retentions of outside professionals or other advisors, including restructuring, investment banking or bankruptcy professionals employed by the company.
- d. any document or other material distributed to any one or more members of the board of directors (whether in that person’s capacity as a member of the board, any committee thereof, or of management).
- e. any proposal, termsheet, agreement, letter of intent, plan, analysis or other communication relating to (i) sale of assets or securities out of the ordinary course, (ii) merger or consolidation of the company or any subsidiary thereof with any other person or entity, (iii) any shutdown of service, termination of activities or abandonment of property or assets, and/or (iv) any other business decision ultimately requiring Bankruptcy Court approval, including any draft study or multiple scenarios for internal review.
- f. any business plan, plan of reorganization, plan of liquidation, or proposed recapitalization, or any draft or segment thereof (including exhibits, appendices, or material to be incorporated therein).
- g. any cash flow reports or memoranda of any kind, including reports of all activity in the DIP loan facilities of the company, and of any draft financial statement or revision thereof.
- h. copies of any proposed retention agreement or motion relating thereto.
- i. copies of all filings with the Bankruptcy Court.

Corporate Monitor had to be granted access to any employee of WorldCom “to discuss any matter deemed relevant to the Corporate Monitor at any time”³⁸ and had to be invited to any meetings or discussions between WorldCom and the persons involved in its bankruptcy proceeding, including, for example, the official creditors committees.³⁹ Pursuant to this authority, Mr. Breeden was entitled to attend all WorldCom board and board committee meetings. The Corporate Monitor’s already expansive authority would soon increase even further, as a result of WorldCom’s consent decree with the SEC.

4. The Effect of the Consent Decree

In November 2002, WorldCom entered into a partial settlement with the SEC.⁴⁰ As part of the consent decree, the Corporate Monitor was required to review WorldCom’s corporate governance⁴¹ and to issue recommendations concerning WorldCom’s future governance structure.⁴² In June 2003, several months before Mr. Breeden’s report was issued, WorldCom

Id. at *5–*7.

38. *See id.* at 5.

39. *See id.* at 6.

40. *See* Judgment of Permanent Injunction Against Defendant WorldCom, Inc., SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. Nov. 26, 2002) [hereinafter WorldCom Permanent Injunction]. As part of the settlement, WorldCom agreed to be permanently enjoined from violating the federal securities laws. This settlement did not include any judgment regarding civil penalties. The parties later agreed that WorldCom would pay a penalty of \$500 million in cash and \$250 million worth of stock in the reorganized company. *See* Consent and Undertaking of Defendant WorldCom, Inc., SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 7, 2003).

41. Specifically, the Corporate Monitor was required to determine:

- (1) whether WorldCom is complying with recognized standards of “best practices” with respect to corporate governance;
- (2) whether WorldCom has sufficient policies and safeguards in place (a) to ensure that WorldCom’s Board of Directors and all committees of WorldCom (including without limitation the audit committee and the compensation committee) have appropriate powers, structure, composition, and resources and (b) to prevent self-dealing by management;
- (3) whether WorldCom has an adequate and appropriate code of ethics and business conduct, and related compliance mechanisms; and
- (4) whether WorldCom has appropriate safeguards in place to prevent further violations of the federal securities laws.

WorldCom Permanent Injunction, *supra* note 40, at 5–6.

42. The Judgment of Permanent Injunction also required that, following the Corporate Monitor’s report, the WorldCom board was required to report back to the court and the SEC “with respect to the decisions and actions taken as a result of each of the” Corporate Monitor’s recommendations. *Id.* at 6.

stipulated that it would adopt each of the Corporate Monitor's corporate governance recommendations in full.⁴³

5. The Corporate Monitor's Report

In August 2003, Mr. Breeden issued his well-publicized corporate governance report, *Restoring Trust*.⁴⁴ In the 147 page report, the Corporate Monitor made 78 recommendations, including some that have been considered quite controversial.⁴⁵ Many of the recommendations sought to increase shareholder power in the corporation by instituting provisions permitting shareholder nomination of directors,⁴⁶ establishing an "electronic town hall" for shareholder communications,⁴⁷ and requiring the company to include in its proxy statement certain shareholder proposals⁴⁸—even if they could be excluded under the SEC's current proxy rules. Other recommendations were intended to strengthen the performance and effectiveness of the board of directors, including several rules relating to the composition of the board and board committees.⁴⁹ Mr. Breeden also introduced board term limits with his recommendation that the board have at least one new member each year.⁵⁰ In addition, because the Corporate Monitor traced many of WorldCom's problems to its practice of paying excessive compensation to its management, the report contained several rules addressing the amount and form of executive compensation, including bans on the use of stock options⁵¹ and caps on annual executive compensation.⁵² The report also imposed several rules aimed at improving the accuracy and transparency of WorldCom's financial reporting process, including the

43. Stipulation and Order at 2, *SEC v. WorldCom, Inc.*, No. 02 Civ. 4963 (S.D.N.Y. June 11, 2003). If WorldCom later decided that it did not want to adopt one or more of the Corporate Monitor's recommendations, the company would have to seek relief from the court. *See id.*

44. *See* RICHARD C. BREEDEN, *RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC.* (Aug. 2003).

45. For example, a noted corporate lawyer criticized the report, stating that many of the recommendations "have long since been rejected by the regulators and lawmakers who have spent much time and effort considering these matters." Report by Martin Lipton, Mark Gordon, & Laura Muñoz, Wachtell, Lipton, Rosen & Katz, "Restoring Trust" or Losing Perspective? 1 (Aug. 27, 2003), available at <http://www.realcorporatelawyer.com/pdfs/wlrk082803.pdf>. *See also* Letter from Warren de Wied, Fried, Frank, Harris, Shriver & Jacobson, A New Voice in the Corporate Governance Debate: The Recommendations of WorldCom's Corporate Monitor 2 (Sept. 8, 2003), available at http://www.ffhsj.com/cmemos/030909_worldcom_monitor.pdf (stating that many of the recommendations were "highly controversial").

46. *See* BREEDEN, *supra* note 44, at 43.

47. *See id.* at 114.

48. *See id.*

49. *See id.* at 49–60. For example, Mr. Breeden recommended that the WorldCom Board should ordinarily consist of ten directors. *See id.* at 49. All of these directors, other than the CEO, should be independent directors. *See id.* at 50.

50. *See* BREEDEN, *supra* note 44, at 56.

51. *See id.* at 95–96.

52. *See id.* at 82–87.

adoption of a dividend policy with a target payout of annual dividends of at least 25% of the company's annual income.⁵³ Finally, the Corporate Monitor attempted to establish an honest corporate culture at WorldCom through a new legal and ethics program.⁵⁴

B. THE CORPORATE MONITOR'S ACTIVITIES

The above discussion traces the history of the expanding judicial authority of WorldCom's Corporate Monitor, from a person initially charged with prohibiting the destruction of evidence and the payment of excessive executive compensation, to a person who was required to revamp the company's corporate governance structure. As explained in more detail below, Mr. Breeden capitalized on this judicially-created authority and expanded his power even further to become arguably the most powerful person at WorldCom, a person involved in every important corporate decision.

These important corporate decisions included compensation packages for the new management team. In fact, one of Mr. Breeden's first significant actions was the approval of the pay package for Michael Capellas, WorldCom's new Chief Executive Officer. Initially, the Corporate Monitor rejected the WorldCom board's proposed employment agreement with Mr. Capellas, opining that it was "grossly excessive."⁵⁵ Eventually, WorldCom agreed to reduce Mr. Capellas's compensation.⁵⁶ But the Corporate Monitor was not satisfied with merely obtaining this salary concession. Before he would approve the pay package, Mr. Breeden required Mr. Capellas to sign an "Undertaking and Pledge," which required

53. *See id.* at 128.

54. *See id.* at 138–39.

55. *See* Andrew Backover, *Judge Blasts New WorldCom CEO Capellas' Salary Package*, USA TODAY, Dec. 10, 2002, at 6B. Originally, the board proposed a compensation package that would pay Mr. Capellas \$1.5 million in base salary, plus a signing bonus of \$2 million and up to \$1.5 million in performance-based bonuses. He would also receive \$18 million in restricted stock in the post-bankruptcy WorldCom entity. *See* Debtors' Motion Pursuant to Sections 363 and 105 of the Bankruptcy Code for an Order Authorizing the Employment of Michael D. Capellas as President, Chief Executive Officer and Chairman of the Board of Directors of the Debtors, *In re* WorldCom, Inc., Ch. 11 Case No. 02-13533, Ex. A at 2–3, 7–8 (Bankr. S.D.N.Y. Dec. 9, 2002). *See also id.* at 2, 7–9.

56. Under the new compensation package, Mr. Capellas received the same salary, signing bonus, and performance based bonus. However, his restricted stock award was reduced by \$6 million to \$12 million, contingent on the company emerging from bankruptcy, at which time he could receive an additional \$6 million worth of stock, at the discretion of the Monitor and the company's board. *See* Seth Schiesel, *Revised Contract for WorldCom's New Chief Executive Wins Approval From 2 Judges*, N.Y. TIMES, Dec. 17, 2002, at C10. *See also* Supplement to Debtors' Motion Pursuant to Sections 363 and 105 of the Bankruptcy Code for an Order Authorizing the Employment of Michael D. Capellas as President, Chief Executive Officer and Chairman of the Board of Directors of the Debtors, *In re* WorldCom, Inc., Ch. 11 Case No. 02-13533, Ex. A at 7–8 (Bankr. S.D.N.Y. Dec. 16, 2002).

Mr. Capellas to agree to numerous corporate governance initiatives as a condition to employment.⁵⁷

Given the Corporate Monitor's judicial charge to prevent WorldCom from paying excessive compensation, Mr. Breeden's participation in this important corporate decision is not surprising. But a review of Mr. Breeden's activities at WorldCom demonstrates that his power extended well beyond compensation decisions. In fact, the Corporate Monitor actively participated in the general business operations of WorldCom.⁵⁸ His involvement was so significant that he has been described variously as an unofficial "company executive" and "unofficial board member" of the company.⁵⁹ In addition to attending all board meetings and controlling the company's monthly budget, Mr. Breeden was a significant player in high-level corporate negotiations, including, for example, the negotiations that ultimately restored WorldCom's ability to bid on government contracts⁶⁰ and negotiations with WorldCom's creditors.

The Corporate Monitor also shaped WorldCom's board of directors. He chose the new members of WorldCom's board of directors⁶¹ and was instrumental in obtaining the resignation of a shareholder-elected member of the board accused of a conflict of interest transaction during the Bernie Ebbers era, even after the board refused to remove him.⁶²

Perhaps the most significant example of the Corporate Monitor's power at WorldCom was the extraordinarily active role he played in the ultimate decision faced by any corporation: the decision to be acquired by another company. During 2005, two companies—Verizon Communications, Inc. and Qwest Communications International, Inc.—fought for control of WorldCom and required the WorldCom board to choose between the two

57. For example, the Undertaking and Pledge required Mr. Capellas to develop disclosure policies beyond those required by the federal securities laws, to "support robust levels of capital investment in internal controls," to help develop corporate governance mechanisms that will "advance the best interests of shareholders, creditors and the public at large," and to help ensure that the board "has a membership that represents shareholder interests (and stakeholder interests broadly prior to emergence from bankruptcy)." See Order, Ex. A at 5, SEC v. WorldCom, Inc., No. 02 Civ. 4963, (S.D.N.Y. Dec. 16, 2002).

58. In fact, Mr. Breeden had an office at WorldCom's headquarters, right down the hall from the company's CEO. See One on One With Richard Breeden, Corporate Monitor for MCI, Interview on Nightly Business Report (Aug. 26, 2003), available at <http://www.nbr.com/archive/transcript/2003/transcript082603.html#story2> ("[Breeden] has been sitting inside the company, two doors down from the CEO, watching everything that goes on there.").

59. See Lublin & Young, *supra* note 1 (characterizing Mr. Breeden as an "unofficial board member").

60. See *id.* ("Mr. Breeden was a key player in government negotiations that led to . . . restoration as a federal bidder [on government contracts].").

61. See Barnaby J. Feder, *Five are Chosen to Join Board of a Reorganized WorldCom*, N.Y. TIMES, Aug. 30, 2003, at C2 (stating that Mr. Breeden recommended the new members of the board).

62. See Kurt Eichenwald, *WorldCom Director Quits and Agrees to Pay For Using Plane*, N.Y. TIMES, Oct. 29, 2002, at C3 (noting that Mr. Breeden urged the board to remove the director, but the board determined that it did not have the authority to remove a shareholder-elected director).

suitors. Mr. Breeden was directly involved in the company's negotiations with both Verizon and Qwest.⁶³ In fact, some investors criticized the extent of his involvement and alleged that the Corporate Monitor unduly favored Verizon over Qwest in the takeover battle, even though Qwest appeared to offer a higher short term value to WorldCom shareholders.⁶⁴

IV. POTENTIAL DANGERS PRESENTED BY THE USE OF A CORPORATE MONITOR

Although WorldCom is the most well-known example of a Corporate Monitor, the SEC has sought this ancillary remedy in several other recent cases and is likely to use this novel remedy again in the future.⁶⁵ Therefore, it is important to consider the potential dangers associated with the use of a Corporate Monitor.

A. DE FACTO EXPANSION OF CORPORATE MONITOR'S POWER

The appointment of a Corporate Monitor leads to the potential for a de facto expansion of the Corporate Monitor's power. "De facto" expansion means an expansion of the Corporate Monitor's powers beyond those

63. According to WorldCom's public documents, Mr. Breeden participated in the decision to reject Qwest's bid in favor of Verizon. *See, e.g.*, Letter from Nicholas deB Katzenbach, MCI Chairman of the Board, MCI to Richard C. Notebaert, Chairman & CEO of Qwest Communications International, Inc. (Mar. 1, 2005), available at <http://www.verizonbusiness.com/about/news/releases/> (follow 1 March, 2005 MCI Chairman of the Board) ("MCI's Board, with the participation of the court-appointed Corporate Monitor[,] . . . has reviewed all options . . ."). Published reports also indicate that Mr. Breeden was deeply involved in the negotiations. For example, the *Washington Post* reported, "Every time [WorldCom] delves into delicate discussions over whether to merge with Qwest Communications International Inc. or Verizon Communications Inc., it is doing so under the close watch of" the Corporate Monitor. Yuki Noguchi, *The 'Sheriff' of MCI; Watchdog Laid Down Laws Now Affecting Merger Talks*, WASH. POST, Apr. 28, 2005, at E1. *See also* Jesse Drucker & Almar Latour, *Qwest Weighs Proxy Fight for MCI*, WALL ST. J., Apr. 7, 2005, at A6 (reporting that MCI rejected Qwest's bid after the Qwest CEO spoke with Mr. Breeden).

64. *See, e.g.*, Noguchi, *supra* note 63 ("[S]ome shareholders argu[ed] that [Mr. Breeden] has been biased towards Verizon's offer from the start."). *See also* Almar Latour et al., *Verizon Regains an Edge, For Now, In Bid for MCI*, WALL ST. J., Apr. 11, 2005, at A1 ("How could [WorldCom's] corporate monitor and board allow this to happen?") (quoting Leon Cooperman, the chairman and chief executive of Omega Advisors Inc., which owns about 12 million shares of MCI)). In addition to Mr. Breeden's direct influence on WorldCom's decision to be acquired by Verizon, the Corporate Monitor also may have had a more subtle, indirect influence on the outcome. As part of the corporate governance changes made by WorldCom at the direction of the Corporate Monitor, the WorldCom board adopted certain guidelines. According to these guidelines, the WorldCom board's role was to "maximize the long-term value of the Company for its shareholders" by, inter alia, "addressing the concerns of other interested parties including employees, customers, suppliers, government and regulatory officials, communities and the public at large." *See* MCI, INC. CORPORATE GOVERNANCE GUIDELINES (on file with Brooklyn Journal of Corporate, Financial & Commercial Law). By permitting the WorldCom board to focus on long-term value and "other constituencies," these guidelines may have helped defeat Qwest's bid. *See* Ken Belson, *Why MCI Is Turning Up Its Nose at \$1.3 Billion*, N.Y. TIMES, Apr. 10, 2005, at C3.

65. *See supra* note 3.

specifically defined by the relevant court orders. The judicial power to “monitor” or “oversee” a company’s management creates the danger of non-judicial expansion of the Corporate Monitor’s power.

An examination of WorldCom illustrates this phenomenon. The court orders defining the authority of the WorldCom Corporate Monitor did not expressly grant Mr. Breeden the power to participate in the business operations of WorldCom. Nor did the orders authorize Mr. Breeden to negotiate a merger agreement or to select the names of individuals who would serve on the new WorldCom board. Instead, it’s likely Mr. Breeden derived these powers from the Corporate Monitor’s general oversight authority. Judge Rakoff wanted Mr. Breeden to be his eyes and ears so that the court could determine whether WorldCom had changed its ways.⁶⁶ Presumably, if Mr. Breeden was not satisfied with what he observed, he would report back to the court with recommendations, and the court would order WorldCom to comply with Mr. Breeden’s recommendations. This gave Mr. Breeden tremendous leverage to increase his power at the company beyond the scope of his defined authority, and he appeared to do this with the tacit approval of the court.

Mr. Breeden’s de facto power also increased because WorldCom was unlikely to challenge his role at the company. To recover from the tremendous scandal it was vitally important for WorldCom to convince the investing public that the company was fully committed to reform. Any conflict with the Corporate Monitor, no matter how justified, would lead the investing public to conclude that WorldCom was dragging its feet on its promise to become a good corporate citizen. Therefore, WorldCom had to avoid any public disagreement with Mr. Breeden. WorldCom’s strategic decision to accept Mr. Breeden’s active participation in its business permitted the Corporate Monitor’s power to expand to levels the court order had not contemplated. The danger of a de facto expansion of power is inherent in the use of a Corporate Monitor. Thus, any corporation that agrees to accept a Corporate Monitor would be in similar position.

B. POTENTIAL INTERFERENCE WITH MANAGEMENT

When the court appoints a Corporate Monitor with broad powers, he can interfere with the ability of the board and corporate officers to manage the company. The Corporate Monitor may interfere directly if a court defines the Corporate Monitor’s authority to trump decisions made by the

66. As Judge Rakoff explained:

The monitor’s client is a difficult, rather ornery client, namely me, and more abstractedly, the Court, and I want a hands-on monitor. I want a monitor who will report to me what is going on and, more importantly, feel free to look in any nook and cranny that is necessary to fulfill his functions.

WorldCom Transcript of Record, *supra* note 30, at 3.

board or corporate officers. The Corporate Monitor may also interfere indirectly.

The facts of WorldCom demonstrate the potential for direct interference by a Corporate Monitor. For example, although it is the board's role to set executive compensation, the WorldCom judge placed that authority in the hands of the Corporate Monitor. Mr. Breeden used his judicial authority to veto Mr. Capellas's compensation agreement. But by doing so, Mr. Breeden impeded what is arguably the board's most significant responsibility, the selection of a CEO.⁶⁷ Moreover, certain of his corporate governance reforms affected the discretion of WorldCom's officers to manage the company. For example, the ethics pledge signed by Mr. Capellas as a condition to his employment contained several undertakings that restricted his discretion to manage the company.⁶⁸ The CEO's discretion was also impacted by the recommendations set forth in Mr. Breeden's *Restoring Trust* report, which the company agreed to adopt as part of its SEC settlement. The report included a recommended dividend policy, which required WorldCom to set a target of paying annual dividends of at least 25% of annual income.⁶⁹ This cash commitment undoubtedly affected the decisions made by WorldCom's management.

The WorldCom Corporate Monitor also had an indirect—though no less significant—effect on management. The appointment of a Corporate Monitor with broad oversight authority means that a company's management operates under close supervision. This supervision affects the way management performs. For example, in *WorldCom*, the decision to sell the company was made even more difficult for the directors because they had to consider the opinion of the Corporate Monitor. It is likely the CEO had an especially difficult time operating under a watchdog. As one WorldCom board member stated, Mr. Capellas “has sort of been playing with one hand tied behind his back.”⁷⁰ The danger that a Corporate Monitor will interfere with the management necessarily accompanies the appointment of a Corporate Monitor.

C. ACCOUNTABILITY

A related concern is the accountability of the Corporate Monitor. Although a Corporate Monitor effectively may be managing a corporation, he is a court officer, answerable only to the court.⁷¹ The Corporate Monitor

67. And, in fact, Mr. Breeden's insistence on a lower pay package for the new CEO created a real danger that this sought-after executive might take a different offer. See Andrew Backover, *Overseer Confident WorldCom Will Come Back*, USA TODAY, Dec. 30, 2002, at 4B (“[Breeden's veto] irked some creditors who wanted a new CEO as fast as possible.”).

68. See *supra* note 57 and accompanying text.

69. See BREEDEN, *supra* note 44, at 8.

70. See Lublin & Young, *supra* note 1.

71. For example, in *WorldCom*, the judge clarified the Corporate Monitor's status as follows:

is not an agent of the shareholders; he is an agent of the court. The Corporate Monitor's primary responsibility is not to increase shareholder value, or even to benefit shareholders; his primary responsibility is to further the court's order.

The Corporate Monitor's allegiance to the court raises several obvious issues, which can be demonstrated by WorldCom. As discussed above,⁷² Mr. Breeden's initial responsibility was to prevent the destruction of evidence and to preserve corporate assets by prohibiting excessive compensation. Eventually, his primary responsibility shifted to overhauling WorldCom's corporate governance scheme to prevent future fraud. WorldCom shareholders were undoubtedly benefited by Mr. Breeden's reforms. However, a corporation's goals are typically much broader than this and include financial goals, such as increasing sales, decreasing expenses, or improving market share. To the extent that a Corporate Monitor is charged with focusing primarily on one goal, other important goals may be neglected to the detriment of the corporation and its shareholders.⁷³ The idea that a court-appointed individual could be managing a public corporation for long periods of time without any accountability to the shareholders is troubling, to say the least.

D. EFFECT ON ABSENT SHAREHOLDERS

The concern that the Corporate Monitor is accountable only to the court is exacerbated by the fact that the corporation's shareholders have no input into the decision to appoint a Corporate Monitor and are not necessarily even aware that a Corporate Monitor is being considered by the court. As discussed above,⁷⁴ novel ancillary remedies are typically imposed as part of a consent decree between the SEC and the corporation. These two parties to the agreement have every incentive to articulate the advantages of the

The Corporate Monitor, Richard C. Breeden, is an agent of this Court with such oversight responsibilities as set forth in the Court's Order . . . and as the parties may otherwise agree or the Court may otherwise direct. The Corporate Monitor is not an officer, director, employee, or agent of WorldCom and shall not owe any fiduciary duties or other duties or obligations of any kind to WorldCom or WorldCom's directors, officers, employees, shareholders, bondholders or creditor, or any person or entity other than this Court.

Stipulation and Order at 1–2, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 17, 2002).

⁷² See *supra* Part III.A.2.

⁷³ The argument that WorldCom's management could have sought judicial relief if it believed that the Corporate Monitor's actions were harming the corporation is not very persuasive. Even if the judge agreed, the judge would be forced to balance the goal of preventing securities fraud against other corporate goals. Balancing corporate goals is a difficult task, and a single judge would presumably be no better at it than the Corporate Monitor. Indeed, the recognition that these kinds of business decisions are best left to a corporate board is one of the foundations of the business judgment rule.

⁷⁴ See *supra* Part II.C.

appointment of a Corporate Monitor—and no incentive to brief the court on the possible disadvantages. Although the interests of shareholders are significantly affected by the appointment of a Corporate Monitor who may, in effect, be managing the corporation, no one represents the shareholders' interests to the court,⁷⁵ nor are the shareholders likely to represent themselves.⁷⁶

Absent shareholders ultimately bear the costs of the Corporate Monitor. These costs may be substantial,⁷⁷ yet there is no real mechanism in place to control costs.⁷⁸ The district court, which sets the terms of the Corporate Monitor's engagement, has the power to disallow unnecessary or unreasonable Corporate Monitor bills, but it is doubtful that a corporation seeking to rehabilitate its public image would challenge the Corporate Monitor's bills. The absent shareholders are the only group that would have reason to seek to control spending, but they do not have a voice in the SEC proceeding.

E. POTENTIAL SEC OVERREACHING

One of the primary responsibilities of the SEC is to enforce the federal securities laws, including the anti-fraud provisions. The SEC is assisted in its enforcement mission when it obtains the appointment of a Corporate Monitor charged with preventing the destruction of evidence. In addition, a Corporate Monitor who improves a company's corporate governance could help prevent securities fraud, which also assists the SEC in its enforcement mission. But a Corporate Monitor who is empowered to overhaul a company's governance structure also presents a danger of potential overreaching by the SEC.⁷⁹ As the SEC more directly regulates corporate

75. In fact, shareholders seeking to be heard might not be permitted to intervene in the SEC enforcement action. Several courts have interpreted Section 21(g) of the Securities Exchange Act of 1934 to bar intervention absent SEC consent. *See, e.g., SEC v. Wozniak*, 1993 U.S. Dist. LEXIS 1241, at *2 (N.D. Ill. Feb. 8, 1993) (No. 92 C 4691) ("Only SEC's consent can open a door in [the] wall to permit a private party . . . to have access to [the] federal court . . .").

76. Due to collective action problems and rational apathy issues present in most large corporations, shareholders have little incentive to appear in court to discuss the advantages or disadvantages of a Corporate Monitor.

77. For example, WorldCom agreed to pay Mr. Breeden his regular rate of \$800 per hour, as well as to pay for appropriate staff and advisors. *See WorldCom Transcript of Record, supra* note 30, at 3. Mr. Breeden's bills were not made public, but according to estimates, he submitted bills of \$300,000 per month. *See Jonathan D. Glater, In Scandals, Another High Price to Pay*, N.Y. TIMES, Dec. 13, 2002, at C1. Published reports indicate he was paid more than \$2 million for his work as WorldCom's Corporate Monitor. *See Lublin & Young, supra* note 1.

78. Of course, if the company has sought the protection of the bankruptcy laws, the bankruptcy court may seek to control the Corporate Monitor's bills, especially because there may be other constituencies—i.e., company creditors—who may have incentive to object to significant expenses incurred by the debtor company. However, this supervision by bankruptcy court may lead to other difficulties. *See infra* Part IV.H.

79. Possible overreaching by the SEC is not a new concern. As Professor Roberta Karmel has persuasively argued, "The Securities and Exchange Commission . . . has aspired to regulate corporate governance since its inception and, from time to time, has exploited scandals in the

governance, it moves into areas traditionally regulated by state corporate law, raising significant federalism issues.

The federal securities laws have long been seen as disclosure statutes, while state corporate law has been viewed as governing the internal affairs of companies. Recently, this absolute distinction has changed, as SOX provided the SEC with limited power to regulate the internal affairs of public companies.⁸⁰ However, nothing in SOX, or any other provision of the federal securities laws, provides the SEC with overarching power to regulate corporate governance. It is doubtful, for example, that the SEC would be able to promulgate rules requiring shareholder nomination of directors⁸¹ or rules placing caps on executive compensation.⁸² However, that is exactly what the Corporate Monitor did in WorldCom, which raises the concern of SEC overreaching.

The SEC may run afoul of basic procedural protections provided by federal administrative law by choosing the ancillary remedy of a Corporate Monitor to advance SEC initiatives. Ordinarily, administrative agencies, including the SEC, use the rulemaking process to implement the relevant federal statutes.⁸³ According to the Administrative Procedure Act (APA),⁸⁴ rules can be promulgated only after a statutorily-mandated notice and comment period.⁸⁵ By using a Corporate Monitor to further SEC policy, the SEC could be viewed as making an “end run” around the notice and comment requirements of the APA.⁸⁶

public securities markets to achieve this purpose.” See Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 80 (2005).

80. For example, under SOX, the SEC was empowered to promulgate rules directing the national securities exchanges to amend their listing standards to require independent audit committees. See Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1 (Supp. II 2002).

81. For example, the SEC was unable to promulgate rules that would have required shareholder nominations of directors. See Phyllis Plitch, *Moving the Market: SEC Is Stymied on a Final Rule for Shareholder Access to Ballot*, WALL ST. J., Oct. 11, 2004, at C3.

82. Historically, the SEC has sought to regulate executive compensation, but has done so only through disclosure rules. Recently, for example, the SEC proposed rules that would require additional disclosure of compensation. See Executive Compensation and Related Party Disclosure, Securities Exchange Act Release No. 8655, Exchange Act Release No. 53185, Investment Company Release Act No. 27,218 (February 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 239, 240, 245, 249 & 274).

83. Commentators have noted that the SEC has attempted to articulate policy outside of the rulemaking process, through enforcement decisions and through no-action letters. See, e.g., ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 91–98 (Simon & Schuster 1982); Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 948–67 (1998).

84. 5 U.S.C. §§ 551–553 (2000).

85. See *id.* § 553.

86. According to the APA, after the agency has published notice of a proposed rule in the Federal Register, “the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments . . .” *Id.* § 553(c). The agency is required to consider any comments before adopting the final rule. See *id.* Commentators have

The SEC might argue that concerns of agency overreaching are unfounded. After all, the SEC should not be criticized for actions instituted by a judicially-approved Corporate Monitor. However, this argument is not persuasive for several reasons. First, as discussed below,⁸⁷ the SEC plays a significant role in selecting the Corporate Monitor, which puts the SEC in a privileged position to appoint persons who will further agency policies. Second, although this is a relatively new ancillary remedy, most Corporate Monitors thus far have been individuals with close ties to the SEC, such as former senior staff or former Commissioners. And, finally, and perhaps most importantly, the scope of the Corporate Monitor's work will be defined by the terms of a consent decree between the defendant corporation and the SEC. In *WorldCom*, for example, the SEC settlement authorized the Corporate Monitor to overhaul WorldCom's corporate governance,⁸⁸ which suggests that the SEC was seeking to regulate WorldCom's corporate governance through the use of the Corporate Monitor.

The SEC might also argue that one case does not by itself establish overreaching. But it can set a precedent for future appointments of Corporate Monitors with similarly far-reaching powers. The SEC may not even have to seek a Corporate Monitor in order to obtain concessions from companies in enforcement proceedings. The SEC may employ the simple threat of a Corporate Monitor to encourage a company to agree to corporate governance changes as part of its settlement with the SEC. In fact, as discussed below,⁸⁹ that has happened at least once already.

F. SEC INFLUENCE IN SELECTION OF CORPORATE MONITOR

The SEC's influence over the selection of the Corporate Monitor is closely related to the danger of SEC overreaching. It is the court's responsibility to select the Corporate Monitor, but the court will look to the SEC for guidance. There are numerous advantages arising from the SEC's involvement, including the fact that the agency is well-positioned to identify what is probably a small pool of potential candidates for the job. But with those advantages also come some concerns. The candidates suggested by the SEC are likely to have close ties to the agency and thus might have an unconscious enforcement bias. As discussed above,⁹⁰ the SEC may view the appointment of a Corporate Monitor as an opportunity to pursue broader agency initiatives and will therefore suggest individuals who share those beliefs. The Corporate Monitor might also have his own reasons

identified several advantages of this process, including the production of better rules, "enhanced political accountability," and fairness. *See, e.g.*, RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 368-74 (4th ed. 2002).

87. *See infra* Part IV.F.

88. *See supra* Part III.A.5.

89. *See infra* Part IV.G.

90. *See supra* Part IV.E.

to advance the SEC's agenda. Being selected as a Corporate Monitor can be a lucrative job.⁹¹ An individual who serves as a Corporate Monitor will understand that he needs to keep the SEC satisfied if he would like to see his name on an SEC "short list" for a Corporate Monitor position in the future. It is natural for the court to rely on the SEC for assistance in the selection process, but the court needs to recognize that the SEC may recommend candidates who see themselves as answerable to the SEC, as opposed to the court.

G. CONFLICT WITH STATE CORPORATE LAW

A Corporate Monitor may not be legal under state corporate law. As the scope of the Corporate Monitor's power expands, there is a greater potential that his participation will interfere with the statutory scheme contemplated by state corporate law statutes. Although the Supremacy Clause would permit a federal district court to order an ancillary remedy that would cause a company to violate its law of incorporation,⁹² such an order would raise significant federalism concerns.

Several arguments can be made that a Corporate Monitor with far-reaching powers is illegal under state corporate law. First, if a Corporate Monitor can veto board decisions, there is an obvious clash with state corporate statutes that vest the management of a corporation with the board of directors.⁹³ Similarly, if a board agrees to the appointment of a Corporate Monitor, the board might be seen as impermissibly delegating its powers.⁹⁴ In addition, to the extent that the Corporate Monitor is able to overrule decisions of a board, shareholders are deprived of their statutory right to elect the individuals who are supposed to manage the corporation.⁹⁵ The shareholder franchise can also be affected if, like Mr. Breeden, the Corporate Monitor chooses interim directors or forces shareholder-elected directors to resign from the board.

Because the Corporate Monitor is a relatively new remedy that has been ordered in very few cases, courts have not yet had to grapple with its legality. Two courts, a federal district court⁹⁶ and the Delaware Chancery

91. See *supra* note 77 and accompanying text.

92. U.S. CONST. art. VI, cl. 2 ("[T]he Laws of the United States . . . shall be the supreme Law of the Land.").

93. See, e.g., DEL. CODE ANN. tit. 8 § 141(a) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . .").

94. See 1 Rodman Ward, Jr. et al, *Folk on the Delaware General Corporation Law* § 141.1.3 (4th ed. 1999) ("The board may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of the corporation." (citing *Ash v. McCall*, C.C. No. 17132, slip op. at 17 (Del. Ch. Sept. 15, 2000))).

95. See, e.g., DEL. CODE ANN. tit. 8 § 211(b) ("[A]n annual meeting of stockholders shall be held for the election of directors . . .").

96. SEC v. Hollinger Int'l, Inc., No. 04C0336, 2004 U.S. Dist. LEXIS 3240 (N.D. Ill. Mar. 2), *vacated*, 2004 U.S. Dist. LEXIS 9097 (N.D. Ill. May 17, 2004).

Court,⁹⁷ have recently touched upon the issue in related actions. Both cases involve the battle between business tycoon Conrad Black and the independent directors of Hollinger International, Inc. (International), a public company indirectly controlled by Black. International was accused of making certain unauthorized payments to Black and later lying about these payments in public documents filed with the SEC. Following these accusations, the International board created a Special Committee to investigate Black. When Black's misconduct was disclosed, the SEC brought an enforcement action against International, which ultimately entered into a consent decree with the SEC. As part of the settlement, International agreed to permit the Special Committee to continue its investigation into Black. To help effectuate this promise, International also consented to a "springing Corporate Monitor"⁹⁸ provision, which provided that, upon certain triggering events, a "Special Monitor"⁹⁹ would be appointed by the court "to protect the interests of the non-controlling shareholders"¹⁰⁰ of International.¹⁰¹ These triggering events included actions by Black that might hinder the Special Committee's investigation, such as the removal of any International director or the election of any new International director without the approval of 80% of the incumbent board.¹⁰²

In an emergency proceeding, a district court judge approved the consent decree.¹⁰³ Several days later, Black intervened in the SEC's enforcement action, seeking to have the Corporate Monitor provision vacated. He argued that the consent decree impaired his right to remove and elect corporate directors. The district court initially agreed, vacating the Corporate Monitor provision, primarily because the SEC had not given notice to Black of the emergency proceeding. In reaching this decision, the court was careful not to determine whether the Corporate Monitor provision violated state corporate law. It stated that "[a]lthough [Black] has shown [his] voting rights, as protected under Delaware law, could be impaired, the Court, at this time, does not make a finding that the [consent decree] is in

97. *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005).

98. See SEC Obtains Federal Court Order to Protect Shareholders and Preserve Corporate Assets of Hollinger International, Inc., Litigation Release No. 18551, Accounting and Auditing Enforcement Release No. 1946 (Jan. 21, 2004), available at <http://sec.gov/litigation/litreleases/lr18550.htm>; see also Sidley, Austin, Brown & Wood LLP, SEC Update (Aug. 5, 2004), available at <http://www.sidley.com/db30/cgi-bin/pubs/SECAlertAug0404.pdf> ("Hollinger International entered into a consent judgment in which it agreed to a 'springing' corporate monitor.").

99. See *Hollinger*, 2004 U.S. Dist. LEXIS 9097, at *6.

100. *Id.* at 6.

101. The Special Monitor was a familiar name—Richard Breeden, who was also acting as a special advisor to International's Special Committee.

102. See *Hollinger*, 2004 U.S. Dist. LEXIS 9097, at *7.

103. See *SEC v. Hollinger Int'l, Inc.*, No. 04C0336, 2004 U.S. Dist. LEXIS 3240 (N.D. Ill. Mar. 2), *vacated*, 2004 U.S. Dist. LEXIS 9097 (N.D. Ill. May 17, 2004).

contravention of Delaware Corporate law.”¹⁰⁴ The court then stayed its order to permit the parties to fully brief the issue.¹⁰⁵

At the same time the district court was hearing the SEC enforcement action, the Delaware Chancery Court was being asked to decide, among other things, whether Black had breached his fiduciary duties to International.¹⁰⁶ In response, Black argued that a poison pill plan adopted by the International board, when combined with the springing Corporate Monitor provision, was illegal because it violated the *Blasius* compelling justification standard of review.¹⁰⁷ This argument required the court to discuss the Corporate Monitor provision. Although Vice Chancellor Strine did not directly rule on the legality of the remedy,¹⁰⁸ his observations are instructive. He focused on three factors. First, he pointed out that the Corporate Monitor provision was narrowly drafted, noting that it was “tailored to protecting the Special Committee process”¹⁰⁹ Second, he observed that the Corporate Monitor did not have unilateral veto power. According to the court, the consent decree required the Corporate Monitor to go to district court “in order to stop what he perceived as wrongful actions” by Black.¹¹⁰ And, finally, he noted that the Corporate Monitor provision was of “limited duration,” lasting only until International’s Special Committee had completed its work.¹¹¹

Vice Chancellor Strine’s approach to the issue indicates that the legality of the position of Corporate Monitor turns on the grant of authority from the district court. Using the factors he identified in the *Hollinger* opinion, the appointment of a Corporate Monitor with far-reaching powers is arguably a

104. *Id.* at *24.

105. After the rehearing, the district court ultimately decided to deny Black’s motion to vacate the consent decree, relying on the related Chancery Court decision discussed below. The district court held that collateral estoppel precluded Black from re-litigating the legality of the consent decree. According to the district court:

[W]hile the Delaware court did not actually address whether the Consent Judgment was properly entered, the validity of the Consent Judgment, as it operated with the Rights Plan, was actually litigated and essential to the court’s decision that International did not violate Delaware law in enacting the Rights Plan and the Consent Judgment.

Hollinger, 2004 U.S. Dist. LEXIS 9097, at *14.

106. *See Hollinger Int’l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004), *aff’d*, 872 A.2d 559 (Del. 2005).

107. In *Blasius*, the Delaware Chancery Court adopted a heightened standard of review for board action that is taken for the primary purpose of interfering with or impeding with the effectiveness of a shareholder vote. *See Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988). If a court determines that the *Blasius* standard of review should be applied, the board’s action will be struck down unless the board can show a compelling justification, which is an extremely difficult, if not impossible, task. *Id.* at 661.

108. As the Delaware Chancery Court noted, there was no direct challenge to the consent decree before it. *See Hollinger*, 844 A.2d at 1052 n.63.

109. *See id.* at 1089.

110. *Id.*

111. *Id.*

violation of Delaware corporate law. This conclusion is seen by applying the *Hollinger* factors to the WorldCom Corporate Monitor. The authority of WorldCom's Corporate Monitor was not narrowly drafted. Although the judicial grant of authority to the Corporate Monitor was initially tailored to supplement the injunction against the destruction of evidence and the payment of excessive executive compensation,¹¹² Mr. Breeden's authority expanded dramatically to the point where he was re-writing the company's corporate governance provisions¹¹³ and was participating in important business decisions.¹¹⁴ With this kind of authority, one cannot claim that the WorldCom Corporate Monitor's authority was narrowly tailored.

Moreover, unlike the springing Corporate Monitor provision in the *Hollinger* case, WorldCom's Corporate Monitor *did* have veto power over certain WorldCom business decisions. The court order expressly stated that all compensation decisions at WorldCom had to be approved in advance by Mr. Breeden.¹¹⁵ Thus, the WorldCom Corporate Monitor did not have to seek out court approval if he believed that the company was violating the terms of the court order.

Finally, the Corporate Monitor in *WorldCom* was not appointed for a limited term. Rather, the term was quite indefinite. According to the applicable court order, "[t]he term of the Corporate Monitor will cease no later than the date on which the Commission's investigation of this matter concludes, the Court determines the function of the Corporate Monitor is no longer necessary, or the parties so agree."¹¹⁶ In fact, Mr. Breeden continued as Corporate Monitor even after WorldCom settled with the SEC, after WorldCom adopted Mr. Breeden's corporate governance proposals, and even after the company emerged from bankruptcy. It was only after WorldCom was acquired by Verizon that the Corporate Monitor position was terminated,¹¹⁷ approximately two and a half years after his appointment.

Thus, courts must weigh the circumstances of particular situations to determine whether the appointment of a Corporate Monitor is legal under state corporate law. The Chancery Court decision suggests that it depends on the power exercised by the Corporate Monitor.

112. See *supra* Part III.A.2.

113. See *supra* Part III.A.5.

114. See *supra* Part III.B.

115. See *supra* note 43 and accompanying text.

116. WorldCom June 28 Stipulation and Order, *supra* note 28, at 3–4.

117. See *MCI Inc.: SEC Voices No Objection to End of Monitor Review Post-Merger*, WALL ST. J., Dec. 15, 2005, at A12; Global Press Release, MCI, Washington is Final State to Approve Verizon-MCI Transaction (Dec. 23, 2005), http://global.mci.com/ca/news/press_releases/. If WorldCom had not been acquired, Mr. Breeden would probably be winding up his position right about now. See, e.g., Lublin & Young, *supra* note 1 (referring to Judge Rakoff's statement, made prior to the corporate merger, that Mr. Breeden would probably continue as WorldCom's Corporate Monitor for "another two years or so").

H. POTENTIAL CONFLICTS WITH THE BANKRUPTCY COURT

If a corporation with a court-appointed Corporate Monitor has declared bankruptcy,¹¹⁸ the Corporate Monitor or the federal district court actions and powers may conflict with those of the bankruptcy court or the bankruptcy trustee. The potential for conflict arises because a company operating during bankruptcy does so under the supervision of the bankruptcy court. Two judges will therefore be supervising the company's operations, which raises several questions. What would happen if the district court in an SEC enforcement proceeding authorized certain payments by the company, but the bankruptcy judge disallowed them under bankruptcy law? Or what would happen if the bankruptcy court permitted the debtor to make certain payments, but the Corporate Monitor, backed by the federal district court, would not approve them?¹¹⁹ This conflict could have easily arisen in WorldCom if, for example, the district court approved Mr. Breeden's fees as Corporate Monitor, but the bankruptcy judge determined that these fees were not allowed under the Bankruptcy Code.¹²⁰ Fortunately, in WorldCom, the federal district court judge and the bankruptcy judge worked well together.¹²¹ However, there is no guarantee that judges in future cases would be in agreement on such issues. A disagreement between the two courts would raise significant jurisdictional issues that are beyond the scope of this article.

118. This is a realistic possibility. Companies that engage in securities fraud may be forced to seek the protections of bankruptcy law as their true financial condition is revealed. That certainly occurred with companies such as WorldCom, Enron, and Adelphia, each of which declared bankruptcy after the accounting fraud was uncovered.

119. In WorldCom, the District Court Judge actually recognized this danger. After WorldCom declared bankruptcy, the District Court Judge entered an order clarifying the authority of the Corporate Monitor. In that order, Judge Rakoff noted, "The fact that all compensation arrangements must be approved in advance by the Corporate Monitor does not eliminate the requirement that some or all of these expenditures may also need to be approved by the Bankruptcy Court, in accordance with the Bankruptcy Code." See Memorandum Order at 3, SEC v. WorldCom, Inc., 2002 U.S. Dist. LEXIS 14201, at *3 (S.D.N.Y. Aug. 1, 2002) (No. 02 Civ. 4963). However, he raised the specter of a conflict by cautioning that "[w]hat is 'normal' for a company in bankruptcy reorganization may not necessarily be permissible for a company that stands accused of fraud." See *id.* at 3-4.

120. Under the Bankruptcy Code, the company may pay "reasonable compensation for actual, necessary services rendered." 11 U.S.C.A. § 330(a)(1)(A) (West Supp. 2005).

121. Apparently, one near conflict did occur in WorldCom when several firms that had provided advice in connection with WorldCom's bankruptcy case submitted bills to the bankruptcy court. These submissions were made in conformity with the Bankruptcy Code, but had not been previously approved by the Corporate Monitor as required by a budgeting order issued by the District Court. When this came to the attention of the District Court Judge, he issued an order barring WorldCom from paying any of these fees, but indicated he might grant relief from the budgeting order and recommended that the firms submit applications for relief to the court. The District Court Judge directed the Corporate Monitor to review the applications and make recommendations as to whether the firms should be paid. Order at 3-5, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. Nov. 24, 2004).

V. RECOMMENDATIONS

Although the use of the Corporate Monitor raises several significant concerns, this article does not recommend prohibiting the remedy altogether. If used correctly, and in a limited fashion, the Corporate Monitor can be an extremely effective remedy that helps the SEC in its enforcement mission.¹²² Instead, this article argues for restraint, both from the SEC in seeking this remedy and from the courts in granting this remedy.

A. THE SEC SHOULD EXERCISE RESTRAINT IN SEEKING A CORPORATE MONITOR

The concerns addressed above suggest that the SEC should exercise restraint in seeking the appointment of a Corporate Monitor. Indeed, it appears that the SEC is reserving this ancillary remedy only for extreme cases of securities fraud. A high-ranking SEC official stated that the SEC will consider a Corporate Monitor “in unusual circumstances where management has demonstrated it can’t be trusted to act in the best interests of the investors.”¹²³

Given the implications of the Corporate Monitor, the SEC’s caution in seeking the remedy is appropriate and should be commended. However, the SEC must provide more guidance as to when “unusual circumstances” are present and as to when the SEC would conclude that company management “can’t be trusted to act in the best interests of the investors.” Since securities fraud is allegedly involved in many enforcement cases, “unusual circumstances” must mean something more than ordinary corporate misconduct or disclosure violations. Does “unusual circumstances” mean situations where the management is suspected of obstructing justice? On the other hand, several of the Corporate Monitor cases involved allegations that

122. In addition, the appointment of a Corporate Monitor may offer other advantages. Professor James Fanto has recently proposed that the SEC should be empowered to “appoint a corporate governance monitor” for certain public companies, which would have a role similar to that of the bank examiner. James A. Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation 4* (Brooklyn Law Sch. Legal Studies Research Paper Series, Working Paper No. 49, 2006), available at <http://papers.ssrn.com/abstract=873667>. Professor Fanto argues that the presence of an independent monitor will help break down certain psychological impediments preventing the effective supervision of corporate management. See *id.* at 41–44. In addition, according to Professor Fanto, it will have the advantage of:

bringing into the open the paternalistic regulation that is already occurring through the SEC’s enhanced enforcement powers over public firm management and the increasing criminalization of management’s behavior, and of balancing this enforcement with guidance so that SEC regulation does not just punish firm executives without offering them any accompanying benefits.

Id. at 4–5.

123. Sue Reisinger, *Corporate Monitors Catching On*, NAT’L L. J., Oct. 4, 2004, at 8 (quoting Peter Bresnan, then Associate Director of the SEC’s Enforcement Division).

management was stealing from the corporation, either by paying excessive salaries or by outright misappropriation of funds. Does this amount to an “unusual circumstance” that would result in the SEC’s decision to seek this ancillary relief? Or does the SEC have other situations in mind as well?

Similarly, when can the company management no longer be trusted to act in the “best interests of investors?” Once again, the SEC must be envisioning behavior that consists of more than just corporate misconduct or disclosure violations; otherwise, the SEC could conceivably seek a Corporate Monitor in virtually every enforcement action. In several of the Corporate Monitor cases, managers were also accused of criminal violations of the securities laws. Obviously, criminal conduct makes it more difficult to trust managers to act in the “best interests of investors,” but does this mean that the SEC believes that corporate managers cannot be trusted *only* if their conduct is so egregious as to lead to a criminal investigation? If something less than a knowing or intentional violation of the federal securities laws will lead to this determination, what kinds of behavior will lead the SEC to seek a Corporate Monitor? Is the SEC looking for a long-standing pattern of securities fraud, so that there is real concern that the company will continue to violate the securities laws? If that is the case, what would be the effect of replacing the wrongdoers? A company that has cleaned house can be trusted to act in the “best interests of investors,” which suggests that the SEC should not seek a Corporate Monitor in this situation.

Although SEC representatives have publicly stated that the SEC will exercise restraint in seeking this remedy, additional guidance concerning their decision-making process would be helpful.¹²⁴ Published guidance would assist those companies under SEC investigation in making informed litigation decisions, including the decision to consent to a Corporate Monitor or to other novel ancillary remedies. More importantly, by publishing guidance, the SEC will help ensure that it continues to exercise restraint in seeking a Corporate Monitor, reducing the danger of SEC overreaching and will reinforce the extraordinary nature of the remedy. In addition, before seeking the remedy, the staff will have to ascertain that the enforcement guidelines set forth by the SEC have been met.

124. There is precedent for the publication of factors impacting SEC enforcement decisions. In the well-known Seaboard Release, the SEC set forth the criteria it uses in determining “whether, and how much, to credit self-policing, self-reporting, remediation and cooperation” in its decision to bring enforcement actions. See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship to Agency Enforcement Decisions, Exchange Act of 1934 Release No. 44969, Accounting and Auditing Enforcement Release No. 1470, 2001 SEC LEXIS 2210 (Oct. 23, 2001). More recently, the SEC published the factors it will consider in its decision to impose penalties against corporations. See Statement of the Securities and Exchange Commission Concerning Financial Penalties, Press Release No. 2006-4, 2006 SEC NEWS LEXIS 12 (Jan. 4, 2006).

B. COURTS SHOULD APPOINT A CORPORATE MONITOR ONLY IN RARE CASES

In the past, the district court's power to order novel ancillary remedies had been questioned. Following SOX, the court's power to appoint an independent director, or a special investigator, or a Corporate Monitor, is established.¹²⁵ The only limitation on the court's power, that the relief must be "appropriate or necessary for the benefit of investors," is extremely narrow. But just because a court has the power to appoint a Corporate Monitor does not mean it should. As the above discussion demonstrates, appointing a Corporate Monitor raises several significant concerns. In recognition of these concerns, courts should exercise self-restraint when deciding whether to appoint a Corporate Monitor.

Courts should articulate clear judicial standards¹²⁶ that must be met before a Corporate Monitor is appointed to help ensure that this ancillary remedy is used only in rare cases. The court should begin with a presumption that an injunction is ordinarily sufficient to enforce the federal securities laws. To obtain a Corporate Monitor, the court should require the SEC to demonstrate to the court that the injunction is not sufficient to ensure compliance and that there is reason to doubt that the corporation will comply with the injunction. The court should weigh this danger against the dangers that: (1) a Corporate Monitor can significantly interfere with the effective management of a company; (2) a Corporate Monitor is accountable only to the court, to the possible detriment of absent shareholders; (3) a Corporate Monitor can lead to potential overreaching by the SEC; and (4) a Corporate Monitor might conflict with state corporate law. The court should order a Corporate Monitor only if it finds that the danger of non-compliance outweighs these concerns.¹²⁷ If a court decides to appoint a Corporate Monitor, it should issue a written order demonstrating that this discretion-limiting balancing test has been met. In *WorldCom*, Judge Rakoff did not disclose in writing why he decided to order the novel remedy. This lack of scrutiny contrasts sharply with the thorough and thoughtful analysis in the

125. See *supra* notes 25–26 and accompanying text.

126. There is a long history of courts creating rules to limit their equitable powers. The most obvious example is the injunction. Before ordering an injunction, courts ordinarily must find that the moving party would suffer irreparable harm without it. In addition, courts have articulated exacting standards that the SEC must meet before the court will order a receivership. See James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1784–86 (1976).

127. The need for clear judicial standards is especially important because it is unlikely that an order to appoint a Corporate Monitor will be reviewed by an appellate court. If the SEC obtains the appointment of Corporate Monitor through a consent decree, there will be no appeal. In the unlikely event that the Corporate Monitor is appointed in a contested case, the company will have to wait until the case has been heard and the judgment is final before it can appeal the order, meaning that the Corporate Monitor will be overseeing the company during the pendency of the enforcement action. Even if the order is ultimately appealed, the order will be reviewed under the forgiving abuse of discretion standard, which will be difficult for the company to overcome.

court's decision to approve the penalty in the WorldCom case. In a 14-page Opinion and Order, the court assessed whether the penalty would be in the public interest and whether the settlement was "fair, reasonable, and adequate."¹²⁸

The court should give careful scrutiny to its choice of Corporate Monitor. As discussed above,¹²⁹ the SEC may exert too much influence on the selection process. This concern argues for a transparent selection process. To ensure transparency, the court should disclose the names of the potential Corporate Monitors, as well as their resumes.¹³⁰ The court should determine whether the candidates have any ties to the SEC, including whether the SEC has recommended the candidate for any other court-appointed position. The court should also make the financial terms of the engagement of the Corporate Monitor public. The court should explain the choice for Corporate Monitor in reasonable detail.¹³¹

Most importantly, the court should carefully define the scope of the Corporate Monitor's duties. If the court expands the duties of the Corporate Monitor, it should be justified on the record. One of the most troubling aspects of the WorldCom Corporate Monitor was the de facto expansion of his power. Courts should be sensitive to this concern. Similarly, the duration of the Corporate Monitor's appointment should be limited to a defined term. Given the concerns addressed above, courts should be hesitant to permit a Corporate Monitor to exercise broad oversight of a company for an unlimited amount of time.

VI. CONCLUSION

Enforcing the anti-fraud provisions of the federal securities laws is an extremely difficult task, and the SEC needs to have effective weapons in its arsenal to deter corporate misconduct and protect investors. As demonstrated by the Corporate Monitor's role in WorldCom, the appointment of a Corporate Monitor can be an effective weapon for the SEC. However, there are significant dangers inherent in its use, which

128. See SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003).

129. See *supra* Parts IV.A, IV.F.

130. The appointment of a Corporate Monitor raises other disclosure issues, as well. Specifically, a public company must make adequate disclosure of the Corporate Monitor in its public reports. Such disclosure should accurately present the breadth of the Corporate Monitor's authority and describe his influence on the company's management.

131. The transparency of the selection process in WorldCom could have been better. Although there was a public hearing, there is very little information available about the actual selection process, except that Mr. Breeden was chosen by the court from a list of three names jointly provided by the SEC and the company. The transcript reveals very little of the court's deliberative process. The applicable part of the transcript consists of three short paragraphs, noting (1) Mr. Breeden's experience as former Chairman of the SEC and as head of company specializing in corporate turnarounds; (2) that he is a lawyer; and (3) that he owned 6,000 shares of WorldCom stock that he pledged to divest as soon as possible. See WorldCom Transcript of Record, *supra* note 30, at 2-3.

suggest that the SEC should seek a Corporate Monitor only in rare cases. In addition, in recognition of these dangers, courts should develop standards limiting their judicial discretion to order this extraordinary remedy. After all, as Mr. Breeden's quote at the beginning of this article notes, it *is* an unusual role where a judicially-appointed officer has veto power over the audit committee chairman and the CEO, and it should stay that way.