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FAR-REACHING EQUITABLE REMEDIES UNDER THE SECURITIES ACTS AND THE GROWTH OF FEDERAL CORPORATE LAW

ROBERT J. MALLEY*

The attention of the securities bar increasingly has been drawn to the efforts of the Securities and Exchange Commission to pursue novel forms of ancillary relief in civil injunctive actions brought against issuers of securities. These efforts reached a high-water mark in proceedings instituted against Mattel, Inc.,¹ in which the Commission obtained a consent order providing for the appointment to Mattel's board of directors of an independent majority of members satisfactory to the Commission and approved by the court. As was to be expected, this sweeping relief did not pass unnoticed; public comments generally examined the possibility of encroachment by the Commission upon the rights of Mattel's shareholders to elect the company's directors and the efficacy of the remedy to prevent the filing of erroneous financial reports in the future.²

This article will examine the relief obtained by the Commission in the proceedings against Mattel in light of principles which traditionally have been used by the courts to grant or deny requests for ancillary relief in equitable proceedings, and in relation to previous Commission enforcement actions. It will also explore the question of whether the order obtained by the Commission presents a further growth of "federal corporate law" in preemption of state law.

The Mattel Proceedings

In the initial action brought against Mattel, the Commission's complaint alleged that the toy manufacturer had filed false and misleading financial statements with the Commission in violation of the Securities Exchange Act of 1934,³ and that Mattel had issued false and misleading

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1. SEC v. Mattel, Inc., [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,754 (D.D.C. 1974) (initial complaint and injunction); SEC v. Mattel, Inc., [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,807 (D.D.C. 1974) (application for further relief).

2. See, e.g., BUSINESS WEEK, Oct. 12, 1974, at 32; Matthews, SEC's *Won-Lost Mark in '74 Seen Good on Balance*, in *Special Report: SEC '75*, N.Y.L.J., Dec. 16, 1974, at col. 4.

3. 15 U.S.C. §§ 78a-jj (1970).

press releases concerning the results of its operations. The court permanently enjoined Mattel from violating the antifraud and corporate reporting provisions of the Exchange Act⁴ and ordered the corporation to appoint two additional directors who would be unaffiliated with Mattel and satisfactory to the Commission. The court further ordered Mattel to establish a financial controls and audit committee of four directors to review Mattel's accounting procedures and controls, financial reports, and press releases. In addition, the corporation was required to establish a litigation and claims committee of three directors to determine what action should be taken with respect to claims against officers, directors, and employees of Mattel and to approve the settlement of these claims.⁵

After entry of this order, but before implementation of the required ancillary relief, Mattel advised the Commission of certain additional information of a preliminary nature, subject to verification and possible modification. The Commission interpreted this data to indicate that Mattel's financial statements for two additional previous fiscal years and for certain interim reporting periods during one of these years had materially misstated Mattel's financial condition⁶ and the results of operations for these periods, and further, that the financial statements of Mattel for prior and subsequent periods also might have been affected. Based upon this preliminary information, which the Commission viewed as requiring "additional relief for the protection of investors,"⁷ the Commission filed an application for further relief with the District Court for the District of Columbia on October 1, 1974.

In the second proceeding the court noted that it retained jurisdiction to implement the terms of the decree entered in the first proceeding and

4. 15 U.S.C. §§ 78j, m, n (1970).

5. *SEC v. Mattel, Inc.*, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,754 (D.D.C. 1974) [hereinafter cited as *Mattel I*].

6. The Commission's application stated that Mattel's financial statements for the fiscal year ending January 30, 1971, substantially overstated sales, net income, and accounts receivable. Included on the sales overstatement were approximately \$14,000,000 in purported sales which were subject to customer cancellation. The Commission also alleged that adequate adjustments for tooling and inventory obsolescence were not made, resulting in the overstatement of pretax income by as much as \$10,500,000. These inadequate provisions apparently resulted in a material overstatement of Mattel's losses for the fiscal year ending January 29, 1972. The preliminary information received by the Commission further indicated that a \$4,800,000 sale had been incorrectly reflected twice in the issuer's published financial statements. *SEC v. Mattel, Inc.*, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,807, at 96,689 (D.D.C. 1974) [hereinafter cited as *Mattel II*].

7. *Id.* at 96,690.

“all additional decrees or orders appropriate in the public interest or for the protection of investors and to grant such other and further relief as . . . required at law or in equity as requested by either party. . . .”⁸ Accordingly, based upon the Commission’s application and Mattel’s consent⁹ the court filed an amended judgment and order which superseded its order entered in *Mattel I*. In addition to continuing the permanent injunction against Mattel relating to the antifraud and reporting requirements of the Exchange Act, the amended judgment and order required Mattel to appoint to, and maintain on, its board of directors additional, unaffiliated directors sufficient in number to constitute a majority of the board. Such additional directors and all replacements were to be “satisfactory” to both the Commission and Mattel and were to be approved by the court prior to taking office.¹⁰

Under the amended order, Mattel was further required to maintain an executive committee of the board of directors composed of three or more members, the majority of whom at all times would be unaffiliated directors.¹¹ Two additional committees were ordered to be established and maintained. As provided in the first proceeding, a financial controls and audit committee of the board was to hold broad powers relating to Mattel’s financial, accounting, and reporting activities. Three independent directors were to exercise all voting power on matters before the committee; a fourth member, who was permitted to be a Mattel designee, was without voting rights.¹² A litigation and claims committee, consisting of three unaffiliated directors, was to be vested with broad authority in the area of both pending litigation and possible claims which Mattel might have against any of its past or present directors, officers, employees, or controlling persons. This committee was to have the power to commence, settle, or dispose of any such litigation or claims.¹³

The new unaffiliated directors were to appoint a special counsel, satisfactory to the Commission and approved by the court, to investigate matters raised by the Commission’s complaint and application. The special counsel was required to file a report with the court of his findings

8. *Id.* at 96,692.

9. Mattel’s consent was solely for the purpose of the Commission’s proceedings; it did not constitute an admission of any of the allegations contained in the Commission’s complaint or application. *Id.* at 96,692.

10. *Id.* at 96,693.

11. *Id.*

12. *Id.*

13. *Id.* at 96,694.

and recommendations and, as approved by the new directors, to institute actions on behalf of the company against past or present officers, directors, and others.¹⁴ The special counsel was in turn required to retain a special auditor, satisfactory to Mattel, the Commission, and the court, to audit Mattel's defective 1971 and 1972 financial statements and other statements as requested, and to file within four months an auditor's report with the court and the Commission.¹⁵

In addition to the broad scope of the relief ordered, the court's amended judgment and order provided that certain provisions thereof, including those relating to the appointment of the new Mattel directors, the three committees, and the special counsel, would continue in effect for a period of five years from the date of entry, or for such shorter or longer period as the court, upon application of a party, should decree.¹⁶

Statutory Framework

Section 21(e) of the Exchange Act empowers the Commission to bring an action for injunctive relief when it appears that any person "is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions" of that Act or of any rule or regulation promulgated thereunder by the Commission.¹⁷ Section 20(b) of the Securities Act of 1933¹⁸ corresponds in all material respects to section 21(e) of the Exchange Act. Under both statutes, a permanent or temporary injunction or a restraining order will be granted "upon a proper showing." Although neither section

14. *Id.*

15. *Id.* at 96,695.

16. *Id.* at 96,696.

17. Securities Exchange Act of 1934 § 21(c), 15 U.S.C. § 78u(e) (1970). Section 17 of S. 249, 94th Cong., 1st Sess. (1975), the Senate version of the Securities Act Amendments of 1975, would have added the words "has engaged" to the present statutory language "is engaged or is about to engage in . . . a violation" and would have changed the term "proper showing" to "such showing." No such changes were proposed in the companion House bill, H.R. 4111, 94th Cong., 1st Sess. (1975). These proposed amendments were strongly criticized by leading members of the securities bar on the ground that such changes would deprive the federal courts of their "traditional discretion" to decide whether an injunction were actually required to prevent future violations of law, which would be contrary to our concept of separation of powers. Letter from Kenneth Bialkin, Arthur Mathews, Milton Freeman, William Painter, & Manuel Cohen to the Senate and House Conferees on S. 249, May 12, 1975. In the conference which considered the differing House and Senate bills, these changes were not adopted. *See* H.R. REP. NO. 299, 94th Cong., 1st Sess. (1975).

18. 15 U.S.C. § 77t(b) (1970).

expressly authorizes the Commission to seek ancillary relief in civil injunctive actions, it is clearly established that the Commission may obtain the appointment of a receiver in appropriate circumstances.¹⁹ Such ancillary relief flows from the inherent power of a court of equity to do justice and grant full relief,²⁰ and the need for its exercise is to be determined by the facts of each case.²¹

Pursuant to the exercise of such inherent power, receivers have frequently been appointed by courts in situations in which an issuer was insolvent²² and in which investors were threatened with continued injury arising out of the unlawful acts of a broker-dealer.²³ In each instance, however, the motivation underlying such an appointment was to preserve and maintain the status quo in order that necessary steps could be taken to provide relief to those who had been damaged or threatened with injury as a result of the defendant's unlawful activity.²⁴ In one case arising under the Investment Company Act of 1940²⁵ receivers were appointed to take charge of an investment trust and given power to either reorganize its capital structure or liquidate the trust.²⁶ This appointment, however, followed a finding by the court that all but one of the trust's officers and directors had been guilty of a "gross abuse of trust"²⁷ within the meaning of section 36

19. See, e.g., *SEC v. Manor Nursing Center, Inc.*, 458 F.2d 1082 (2d Cir. 1972); *SEC v. Bawler*, 427 F.2d 190 (4th Cir. 1970); *SEC v. S & P Nat'l Corp.*, 360 F.2d 741 (2d Cir. 1966); *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); *SEC v. H.S. Simmons & Co.*, 190 F. Supp. 432 (S.D.N.Y. 1961). See notes 22-24 *infra* and accompanying text.

20. [A]s the Supreme Court has stated with respect to other regulatory statutes, [we conclude with respect to section 20(b) of the Securities Act and by implication section 21(e) of the Exchange Act] that the Congress must be taken to have acted cognizant of the historic power of equity to provide complete relief in the light of the statutory purposes. *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 182 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). Cf. *Aldred Inv. Trust v. SEC*, 151 F.2d 254, 261 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946).

21. See *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 181 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961).

22. E.g., *id.*; *SEC v. H.S. Simmons & Co.*, 190 F. Supp. 432 (S.D.N.Y. 1961).

23. E.g., *SEC v. H.S. Simmons & Co.*, 190 F. Supp. 432 (S.D.N.Y. 1961); see III L. LOSS, *SECURITIES REGULATION* 1508-14 (2d ed. 1961).

24. See *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 181 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); *SEC v. H.S. Simmons & Co.*, 190 F. Supp. 432, 433 (S.D.N.Y. 1961).

25. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -51 (1970).

26. *Aldred Inv. Trust v. SEC*, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946).

27. *Id.* at 261.

of the Investment Company Act,²⁸ which resulted in an order enjoining such persons from continuing to serve as officers and trustees of the investment trust. Inasmuch as section 36 expressly requires the injunctive relief granted in that case,²⁹ it is clear that the appointment of receivers empowered to function as directors or officers of investment companies is not dependent upon a court's inherent powers, but finds authorization in the express language of the statute. Neither section 21(e) of the Exchange Act nor section 20(b) of the Securities Act contains an analogous statutory requirement; under these Acts, therefore, the appointment of officers or directors is dependent entirely upon the court's inherent equity powers.

Previous Commission Enforcement Actions

Commencing in 1973, the Securities and Exchange Commission began to pursue a more imaginative approach to consent settlements of civil injunctive proceedings brought against issuers under the various securities Acts. Although the Commission has not abandoned requests for the appointment of an equity receiver,³⁰ it has more frequently requested that additional members, independent of the defendant issuer, be appointed to its board of directors,³¹ that certain committees of the board of directors be established,³² or that an independent special counsel

28. 15 U.S.C. § 80a-35 (1970).

29. Under the Investment Company Act, if allegations of a breach of fiduciary duty by the directors or officers of a registered investment company are established, such persons may be enjoined from continuing to act in an official capacity. 15 U.S.C. § 80a-35(a) (1970).

30. SEC Litigation Release No. 6518 (Sept. 16, 1974) (SEC v. National Farmers Org. (S.D. Iowa 1974)); SEC Litigation Release No. 6512 (Sept. 17, 1974) (SEC v. United States Tank Car Corp. (N.D. Cal. 1974)).

31. SEC Litigation Release No. 6540 (Oct. 9, 1974) (SEC v. Seaboard Corp. (C.D. Cal. 1974)) (two new directors appointed); SEC Litigation Release No. 6441 (July 18, 1974) (SEC v. Canadian Javelin, Ltd. (S.D.N.Y. 1974)) (board of directors to be reconstituted so that outside independent directors constitute 40 percent of the directorate); SEC Litigation Release No. 6054 (Sept. 12, 1973) (SEC v. Coastal States Gas Corp. (S.D. Tex. 1973)) (board of directors increased from 10 to 13 members, with 6 new directors to be elected); SEC Litigation Release No. 6142 (Nov. 9, 1973) (SEC v. Westgate-California Corp. (S.D. Cal. 1973)) (board of directors reconstituted to seven, five to be appointed by the court).

32. SEC Litigation Release No. 6670 (Jan. 8, 1975) (SEC v. Alleghany Beverage Corp. (D.D.C. 1975)) (independent audit committee to be established composed of unaffiliated persons acceptable to the Commission and corporation and approved by the court); SEC Litigation Release No. 6142 (Nov. 9, 1973) (SEC v. Westgate-California Corp. (S.D. Cal. 1973)) (executive committee to be established); SEC Litigation Release No. 6054 (Sept. 12, 1973) (SEC v. Coastal States Gas Corp. (S.D. Tex. 1973)) (executive

under court supervision be appointed to pursue, on behalf of the issuer's shareholders, possible causes of action against third persons, directors, or officers of the issuer.³³ In addition, the Commission was successful in obtaining as ancillary relief in a civil injunctive proceeding the appointment of an unaffiliated majority of directors on two occasions prior to its proceedings against Mattel,³⁴ and, in another case, requested that a shareholders' meeting be called for the purpose of voting upon the continuation of the company's management.³⁵

Because the appointment of receivers has generally been based upon the need to maintain the status quo until relief can be afforded to persons who have been damaged by violations of the securities laws,³⁶ it must be determined why the appointment of additional directors, perhaps constituting a majority of a company's board of directors, is thought to be necessary in situations in which the Commission seeks an injunction against continued violations of the Exchange Act. In *Mattel I*, *Mattel II*, and other cases in which the Commission has obtained the appointment of additional directors to a company's board of directors,³⁷ or the establishment of new directors' committees,³⁸ the Commission appears to be concerned as much with the issuer's future conduct as with its past behavior.³⁹ Indeed, in announcing the issuance

committee, with its own independent legal counsel and independent audit committee to be established); SEC Litigation Release No. 6441 (July 18, 1974) (*SEC v. Canadian Javelin, Ltd.* (S.D.N.Y. 1974)) (compliance committee, a majority of whose members to consist of independent outside directors, to be established).

33. SEC Litigation Release No. 6142 (Nov. 9, 1973) (*SEC v. Westgate-California Corp.* (S.D. Cal. 1973)); SEC Litigation Release No. 6441 (July 18, 1974) (*SEC v. Canadian Javelin, Ltd.* (S.D.N.Y. 1974)); SEC Litigation Release No. 6593 (Nov. 21, 1974) (*SEC v. Charter Sec. Mgmt. Corp.* (C.D. Cal. 1974)); SEC Litigation Release No. 6540 (Oct. 9, 1974) (*SEC v. Seaboard Corp.* (C.D. Cal. 1974)).

34. SEC Litigation Release No. 6593 (Nov. 21, 1974) (*SEC v. Charter Sec. Mgmt. Corp.* (C.D. Cal. 1974)); SEC Litigation Release No. 6142 (Nov. 9, 1973) (*SEC v. Westgate-California Corp.* (S.D. Cal. 1973)).

35. SEC Litigation Release No. 6582 (Nov. 12, 1974) (*SEC v. Readex Elec., Inc.* (W.D.N.Y. 1974)) (injunction proceeding in which the corporate and individual defendants were alleged to have violated, and to have aided and abetted violations of, sections 5(a) and 5(c) of the Securities Act, 15 U.S.C. §§ 77e(a), (c) (Supp. I, 1971)).

36. See notes 22-24 *supra* & accompanying text.

37. See note 31 *supra* & accompanying text.

38. See note 32 *supra* & accompanying text.

39. If the Commission had desired to maintain the status quo and grant relief to those damaged by the past violations, it could have appointed a person or persons, unaffiliated with Mattel, to prepare corrected financial statements and reports covering the periods in question. These financial statements and reports could have been filed with the Commission and, to the extent required by the Exchange Act or the court, sent to Mattel's

of the court's order in *Mattel I*, the Commission expressly acknowledged that the two committees which were ordered to be established were "calculated to avoid a repetition of the alleged violations" of the antifraud and reporting provisions of the Exchange Act.⁴⁰ Presumably, this rationale also supported the Commission's request for the even broader ancillary relief sought in *Mattel II*. The Commission thus appears to have reinterpreted the scope of the court's inherent equity powers under the Exchange Act and the Securities Act to include not only remedial maintenance of the status quo, but also extensive regulation of future operations.

The Standard of Necessity

Notwithstanding any question concerning the validity of this apparent reinterpretation of the scope of the court's power under the securities Acts, it remains well established that the exercise of the equity power, whatever its breadth, depends upon the necessity in a given case.⁴¹ At issue in applications of such sweeping remedies as those imposed in *Mattel II* is whether the relevant standard of necessity has been met. Unfortunately, because the proceeding against Mattel culminated in the entry of an order to which the corporation consented, rather than an order which issued following a hearing on the merits, a definitive answer to this question cannot now be offered, but must await a subsequent Commission proceeding. One can only speculate as to how the district court would have applied the standard of necessity in *Mattel II*. However, it is possible to raise certain questions which should provide some substance to the judicial standard of necessity.

Given the expansive ancillary relief calculated to regulate Mattel's future conduct which was sought and obtained by the Commission,⁴² the inhibiting effect the permanent injunction was seen as having upon the future conduct of Mattel, its directors, and its officers may be questioned. Despite the fact that only Mattel was named as a party defendant in the proceeding, Federal Rule of Civil Procedure 65(d) clearly provides that the injunction would also bind the officers, direc-

shareholders and made available to those persons who had been Mattel shareholders during the periods in question and who might be in a position to institute private actions against Mattel to recover any damages suffered as a result of false and misleading financial statements and reports.

40. SEC Litigation Release No. 6467 (Aug. 20, 1974) (SEC v. Mattel, Inc. (D.D.C. 1974)).

41. See note 21 *supra* & accompanying text.

42. See notes 8-16 *supra* & accompanying text.

tors, and employees of Mattel.⁴³ Thus, it appears that the Commission placed little reliance upon the deterrent effect of the injunction to ensure future compliance with the relevant provisions of the Exchange Act, and proceeded to substitute its determination of the appropriate remedy for the judgment of Congress.

Even assuming the propriety of imposition by the Commission of safeguards designed to avoid repetition of the allegedly illegal conduct, the necessity for the sweeping remedy obtained in *Mattel II* seems questionable, in light of the injunctive relief provided by the statutes. One factor which may have motivated the Commission to seek such expansive relief was the fact that five of the six Mattel directors in office at the time the Commission filed its complaint in *Mattel I* were "inside directors" of the company.⁴⁴ This composition of directors could have led the Commission to conclude that Mattel's future conduct would parallel its past behavior. It would seem, however, that this concern could have been alleviated by the appointment of a single individual unaffiliated with Mattel, or of independent directors, constituting less than a majority of the board, to exercise only the powers necessary to monitor Mattel's financial operations in accordance with the court's order in *Mattel I*. The effect of the relief granted in *Mattel II* was to place complete control and responsibility for all of Mattel's business operations in the hands of outsiders who might not be familiar with important aspects of Mattel's business.

43. Every order granting an injunction and every restraining order shall set forth the reasons for its issuance; shall be specific in terms; shall describe in reasonable detail, and not by reference to the complaint or other document, the act or acts sought to be restrained; and is binding only upon the parties to the action, their officers, agents, servants, employees, and attorneys, and upon those persons in active concert or participation with them who receive actual notice of the order by personal service or otherwise.

FED. R. CIV. P. 65(d). The court's order reflects the scope of this rule by binding "Mattel and its officers, agents, servants, employees, attorneys-in-fact, assigns, and successors." *SEC v. Mattel, Inc.*, [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,807, at 96,692 (D.D.C. 1974).

44. See Proxy Statement of Mattel, Inc., Apr. 30, 1974, at 4-7 (hereinafter cited as Proxy Statement). Two of the nominees for reelection as directors at the 1974 annual meeting of stockholders were chairman of the board of directors and chief executive officer, and president and chief operating officer, respectively. Two other nominees served as chairmen of the board and as a consultant to Mattel and a salaried member of the president's staff, respectively. A fifth nominee also served as a member of the president's staff, for which he presumably received some form of compensation from Mattel. The sixth nominee was a partner in a law firm which rendered legal services to Mattel.

It is submitted that questions such as those raised above strongly suggest that the standard of necessity required to justify the granting of the sweeping ancillary relief provided in *Mattel II* was not met. Furthermore, any additional relief for the protection of investors which may have been obtained as a result of *Mattel II* must be weighed against the incursion upon established principles of state corporate law.

State Corporate Law

The Commission's requested ancillary relief in *Mattel II* entered an area of corporate law, regulation of the election and removal of directors, which traditionally has been controlled by the states. As a related matter, the Commission also implicitly assumed the power, previously within the exclusive province of a corporation's directors or shareholders, to effect an amendment of the corporation's bylaws and to increase the number of authorized directors.⁴⁵

It is a recognized principle of corporate law that the business of a corporation must be managed by a board of directors⁴⁶ elected by the corporation's shareholders.⁴⁷ State corporation statutes vest in the shareholders the right to elect directors⁴⁸ who serve for the term specified in the corporation's bylaws; generally, directors are elected at the annual meeting of shareholders.⁴⁹ While the shareholders' right to choose directors is not exclusive, since applicable statutory, charter, or bylaw provisions may empower directors to fill vacancies on the board,⁵⁰ directors chosen to fill vacant positions are generally appointed for a term expiring at the next annual meeting of shareholders,⁵¹ even in the case of a classified board.⁵² Correlative to the shareholders' reserved

45. See Proxy Statement, *supra* note 44, at 3 ("Effective at the time and for the purposes of the Annual Meeting . . . the number of directors of Mattel as fixed by the Board of Directors, pursuant to the By-Laws of the Company, is 6.")

46. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1974); N.Y. BUS. CORP. LAW § 701 (McKinney 1963). See H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS § 207 (2d ed. 1970).

47. *E.g.*, DEL. CODE ANN. tit. 8, § 211(b) (Supp. 1974); N.Y. BUS. CORP. LAW § 602(b) (McKinney 1963).

48. *E.g.*, DEL. CODE ANN. tit. 8, § 211(b) (Supp. 1974); N.Y. BUS. CORP. LAW § 602(b) (McKinney 1963). See H. HENN, *supra* note 46, §§ 188-92.

49. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1974); N.Y. BUS. CORP. LAW § 703 (McKinney 1963).

50. *E.g.*, DEL. CODE ANN. tit. 8, §§ 223(a), (d) (Supp. 1974); N.Y. BUS. CORP. LAW § 705(a) (McKinney Supp. 1975). See H. HENN, *supra* note 46, § 205.

51. *E.g.*, N.Y. BUS. CORP. LAW § 705(c) (McKinney Supp. 1975).

52. See N.Y. BUS. CORP. LAW §§ 704(c), 705(c) (McKinney Supp. 1975). *Contra*, DEL. CODE ANN. tit. 8, § 223(b) (Supp. 1974).

right to elect the members of the board, directors of a corporation may not take any action designed to perpetuate themselves in office.⁵³

The sweeping relief obtained by the Commission in *Mattel II* clearly encroached upon the rights granted to Mattel's shareholders by Delaware, the state of Mattel's incorporation.⁵⁴ As a result of the order, a new majority of directors was installed in office without the benefit of an informed vote of Mattel's shareholders.⁵⁵ Furthermore, it was highly possible that, under the terms of the court's order in that proceeding, these new directors would remain in office for several years,⁵⁶ thereby effectively precluding the shareholders from exercising their right to reelect or replace their directors at each annual meeting.

In addition to usurping the right of Mattel's shareholders to elect directors, the appointment of the new majority to the Mattel board and the accompanying requirements that the majority of both the executive committee and the financial and audit committee, as well as the entire membership of the litigation and claims committee, be selected from the new directors could be viewed as resulting in the de facto removal of the incumbent Mattel directors. An amendment to the Delaware corporation law, effective July 11, 1974, specifically dealt with the removal of directors,⁵⁷ adopting the previously recognized common law rule that shareholders have the inherent power to remove directors for cause. This removal power persists even if directors are elected cumulatively, as were members of Mattel's board.⁵⁸ Although no reported Delaware decision previously had delineated the right of shareholders to remove without cause a director who had been elected by cumulative voting, the statutory amendment recognized that right of removal by limiting the shareholders' ability to remove directors without cause to a number constituting less than the entire board.⁵⁹ In the absence of an explicit authorization pursuant to a statute, char-

53. See, e.g., *Silverman v. Gilbert*, 185 So. 2d 373 (La. Ct. App. 1966); *In re Dollinger Corp.*, 51 Misc. 2d 802, 274 N.Y.S.2d 285 (Sup. Ct. 1966).

54. See Proxy Statement, *supra* note 44, at 2.

55. The proxy rules promulgated by the Commission under section 14 of the Exchange Act, 15 U.S.C. § 78n (1970), applicable to Mattel, are intended to provide shareholders with a certain amount of information concerning new nominees to a board of directors. See *Laurenzano v. Einbender*, 264 F. Supp. 356, 362 (E.D.N.Y. 1966).

56. See notes 9-16 *supra* & accompanying text.

57. DEL. CODE ANN. tit. 8, § 141(k) (Supp. 1974).

58. *Campbell v. Loew's Inc.*, 36 Del. Ch. 563, 134 A.2d 852 (1957), see H. HENN, *supra* note 46, § 192.

59. DEL. CODE ANN. tit. 8, § 141(k) (Supp. 1974).

ter, or bylaw, Mattel's directors could not have been removed by the shareholders without cause.⁶⁰

Although a director may be removed for cause under Delaware law, some degree of due process must be afforded the aggrieved party. A director is entitled to formal notice of the grounds upon which he is to be removed and an opportunity at the corporation's expense to present a statement in his defense to the shareholders either preceding or accompanying the corporation's proxy solicitation materials relating to the removal.⁶¹ A recitation of those acts or omissions which have been held to constitute "cause" is beyond the scope of this article. Nevertheless, it is sufficient for present purposes to point out that while under the relevant principles of Delaware corporate law the shareholders of a corporation clearly may remove a director for cause, that power is circumscribed by due process requirements and may not be exercised in an arbitrary or capricious manner.⁶²

The Commission, on the other hand, clearly lacks specific statutory authority to seek the removal of directors of public corporations which are subject to the Exchange Act. It likewise lacks a statutory mandate analogous to Section 36 of the Investment Company Act to prevent directors of such companies from continuing to act or hold office.⁶³ Whether the Commission should be allowed to accomplish indirectly that which it may not attempt directly is questionable, whether through the use of a procedure which results in the neutralization of the incumbent directors and facilitates their subordination in the management of the business to newly-appointed, nonelected outside directors, or through the de facto removal of the incumbents under circumstances in which the corporation's shareholders might be unable to exercise their right of removal.

60. Presumably, a provision in the corporation's charter or bylaws authorizing the removal by the shareholders without cause of a director elected by cumulative voting would have been upheld under Delaware law. See *Everett v. Transnation Dev. Corp.*, 267 A.2d 627 (Del. Ch. 1970). But cf. *Essential Enterprises Corp. v. Automatic Steel Prod., Inc.*, 39 Del. Ch. 93, 159 A.2d 288 (1960); DEL. CODE ANN. tit. 8, § 141, Comment (1974).

61. E.g., *Campbell v. Loew's Inc.*, 36 Del. Ch. 563, 575-79, 134 A.2d 852, 859-60 (1957). A director apparently is entitled to fundamental due process rights despite the fact that Delaware has no specific statute governing removal procedures and the circumstances under which removal can be effected. DEL. CODE ANN. tit. 8, § 141, Comment (1974).

62. See *Bruch v. National Guarantee Credit Corp.*, 13 Del. Ch. 180, 186, 116 A. 738, 741 (1922).

63. 15 U.S.C. § 80a-35(a) (1970). See notes 28-29 *supra* & accompanying text.

Conclusion

It is submitted that, in the absence of the most compelling circumstances, prevailing public policy concepts dictate that questions of intracorporate relationships and responsibilities are subjects to be dealt with under the laws of the state of incorporation. The broad ancillary relief granted to the Securities and Exchange Commission in *Mattel II* has no express basis in the Exchange Act, or in the legislative history of that Act. The relief results in significant incursions into areas heretofore thought to be exclusively within the province of state corporate law. Due to the obvious political questions raised by such incursions, it is appropriate for Congress to consider whether the Commission should in fact have the kind of power exercised in *Mattel II*. Until Congress does consider this question, the federal courts must deal with the issues discussed in this article on a case-by-case basis. Because the consent order procedure does not afford an opportunity to weigh these issues on their merits, their consideration will depend upon a court which has the independent determination to inquire into the Commission's authority to exercise the sweeping powers discussed in this article.