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WHEN IS A CORPORATE EXECUTIVE “SUBSTANTIALLY UNFIT TO SERVE”?

JAYNE W. BARNARD*

The recently enacted Securities Enforcement Remedies and Penny Stock Reform Act of 1990 provides that, in an SEC enforcement action, a federal court may enjoin or “disbar” the defendant from serving in the future as an officer or director of a public company. A court may enter such an order if it finds that the defendant is “substantially unfit” to serve as a corporate executive; the Act, however, does not define “substantial unfitness.” In this Article Professor Jayne Barnard provides a framework for defining this term and identifying the defendants to which the Remedies Act should apply.

Professor Barnard begins by looking at the legislative history of the Act, but finds little guidance there. She then examines three lines of non-Act cases in which courts have addressed questions closely related to the question of executive unfitness. She rejects these models as well as a fourth, which derives from a British statute similar to the Act. Looking at the standards for imposition of other types of injunctions under the securities laws, and taking into account current criminological knowledge concerning white-collar recidivism, Professor Barnard concludes by establishing a seven-factor test to define “substantial unfitness” under the Act.

In October 1990 President Bush signed into law the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act).¹ The Remedies Act provides that, in an enforcement action by the Securities Exchange Commission (SEC or Commission), upon finding that a defendant has violated either section 17(a)(1) of the Securities Act of 1933² or section 10(b) of the Securities Exchange Act of 1934,³ a federal court may, in addition to ordering monetary sanctions or injunctive

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1. Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C.S.).

2. 15 U.S.C. § 77q(a)(1) (1988).

3. 15 U.S.C. § 78j(b) (1988).

relief, enter an order temporarily suspending or permanently barring the defendant from serving as an officer or director of any public company. This extraordinary executive disqualification provision codifies the long-standing SEC practice of seeking such orders even in the absence of statutory authorization.⁴ With the Remedies Act now in place, executive suspension or bar orders (Remedies Act orders) are unquestionably legitimate remedies, at least when the requirements of the Act are satisfied. What is unclear, however, is what those requirements may—or should—include.

The statutory standard courts are to apply in determining whether to enter a Remedies Act order is whether the SEC has shown that the defendant is “substantial[ly] unfit[] to serve as [a corporate] officer or director.”⁵ The Remedies Act does not define “substantial unfitness,” and the legislative history of the Act provides little guidance as to what Congress may have intended by the phrase.⁶ Moreover, SEC enforcement officials have been reluctant to speculate on how they are likely to interpret this standard⁷ and only recently have begun to explore its application.⁸ Thus, corporate executives are understandably uncertain about

4. See Jayne W. Barnard, *The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them*, 65 NOTRE DAME L. REV. 32, 38-41 (1989).

5. The section reads in full:

In any proceeding [under the applicable enabling subsection] the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated [the applicable penal provision] from acting as an officer or director of any issuer that has a class of securities registered pursuant to section [12 of the Securities Exchange Act of 1934 or that is required to file reports pursuant to section 15(d) of such Act] if the person's conduct demonstrates substantial unfitness to serve as an officer or director of any such issuer.

15 U.S.C.S. § 77t(e) (Law. Co-op. 1991); see *id.* § 78u(d)(2) (Law. Co-op. Supp. 1991).

6. See *infra* text accompanying note 28.

7. See, e.g., *Focus: Courts' Power to Bar Service as Officer or Director, No Longer Controversial, Still May Raise Difficult Issues*, BNA CORP. COUNS. WKLY., Nov. 21, 1990, at 7, 8 (reporting that Bruce A. Hiler, Associate Director, SEC Enforcement Division, refuses to predict the kinds of cases in which the staff will seek suspension and bar orders but cautions that “there will be appropriate cases”).

8. The SEC first announced its intention to seek a bar order under the Remedies Act in March 1991. See David D. Sterns, Litig. Release No. 12,802, 1991 SEC LEXIS 502, at *3, 1991 WL 296465 (S.E.C.) at *4 (Mar. 11, 1991) (announcing lawsuit against defendant Sterns and others, seeking “the maximum penalties available pursuant to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 and a bar against serving as an officer or director of any publicly-held company”). Since then, the SEC has announced its intention to seek bar orders in several other cases. See Charles Keating III, Litig. Release No. 13,118, [6 Topical Law] Fed. Sec. L. Rep. (CCH) ¶ 73,813, at 63,026, 63,029 (Dec. 12, 1991); Robert D. Sparrow, Litig. Release No. 13,011, [1987-1991 Accounting & Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,792, at 63,379-14, 63,379-14 (Sept. 30, 1991); John R. Ward, Litig. Release No. 12,993, [1987-1991 Accounting & Auditing Enforcement

what "substantial unfitness" means, or should mean, especially in a society that until now has assumed that questions of executive fitness are exclusively in the domain of the market.

Typically, executives assembling a management team take into account subjective factors, including a candidate's general and specific business expertise, her ability to complement other available management skills, compatibility with the organizational culture, and often such indefinable characteristics as "synergy" and "sizzle." The choices required in selecting top-level managers are usually complex⁹ and always idiosyncratic to a given organization.¹⁰

The task of executive selection is complicated by its inevitable uncertainties. A particular candidate's "fitness to serve" may not always be evident. For example, personal rectitude and proven leadership skills in a nonbusiness context are not always useful predictors of managerial success.¹¹ By the same token, significant character flaws and even prior unlawful conduct do not always signal an inability to lead effectively.¹² Given these uncertainties, one could fairly argue that, like other matters

Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,788, at 63,379-8, 63,379-8 to 63,379-9 (Sept. 26, 1991). The Commission already has settled two cases under the new provision. See Robert Levin, Litig. Release No. 13,180, 1992 SEC LEXIS 596, at *2, 1992 WL 45945 (S.E.C.) at *1-*2 (Mar. 3, 1992) (prohibiting defendant from serving as officer or director of any public company for 10 years); Delta Rental Sys., Inc., Litig. Release No. 13,073, [6 Topical Law] Fed. Sec. L. Rep. (CCH) ¶ 73,805, at 63,014, 63,014 (Oct. 29, 1991) (permanently enjoining defendant CEO from acting as an officer or director of any public company).

9. The SEC has long recognized the complexity involved in selecting corporate executives. In *In re Franchard Corp.*, 42 S.E.C. 163 (1964), the late Commission Chairman William Cary conceded that "[m]anagerial talent consists of personal attributes, essentially subjective in nature, that frequently defy meaningful analysis The integrity of management—its willingness to place its duty to public shareholders over personal interest—is an equally elusive factor." *Id.* at 170.

10. See CHARLES ANDERSON & ROBERT ANTHONY, *THE NEW CORPORATE DIRECTORS—INSIGHTS FOR BOARD MEMBERS AND EXECUTIVES* 89 (1986) (noting that regional banks, for example, require very different directoral skills from those required by defense contractors or fashion retailers).

11. See, e.g., JAMES RESTON, JR., *THE LONE STAR: THE LIFE OF JOHN CONNALLY* 588-610 (1989) (describing the financial collapse of the business empire of John Connally, former Governor of Texas and Secretary of the Treasury); Dean Foust et al., *Al Haig: Embattled in the Boardroom*, BUS. WK., June 17, 1991, at 108, 108 (noting that former Secretary of State's international reputation and expertise did not save two companies on whose boards he served from seeking protection under Chapter 11 of the Bankruptcy Code); Kevin Kelly, *The Education of Bobby Inman*, BUS. WK., Dec. 18, 1989, at 50, 50 (reporting that former Navy admiral and deputy director of the CIA failed as CEO of defense contractor Tracor, Inc.).

12. A number of business executives have led strong companies and created new shareholder wealth after an initial run-in with the law. See Dyan Machan & Graham Button, *Beyond the Slammer*, FORBES, Nov. 26, 1990, at 284, 284-86 (recounting the comebacks of Albert Nipon (jailed for income tax evasion), Peter Brant (convicted of insider trading), David Begelman (convicted of embezzlement), and Paul Thayer (convicted of insider trading)). For a broader discussion of the relationship between character and leadership, see THOMAS REEVES,

of business judgment, determining whether a candidate is fit to serve as a high-level corporate manager is a task singularly unsuited to federal court judges.¹³ Indeed, executive selection involves the sort of risk-based analyses that courts typically try to avoid.¹⁴ Yet, with the enactment of the Remedies Act, Congress has indicated (1) that substantial unfitness (and therefore presumably its converse, "substantial fitness") for high corporate office must be capable of objective definition and (2) that federal courts are appropriate participants in the crafting of that definition.

Because the federal courts will inevitably have to undertake this task and apply the Remedies Act to defendants appearing before them, it is time to consider how judges might approach the substantial-unfitness question. There are several possible starting points. Judges often must measure the fitness of corporate executives in contexts not involving the Remedies Act: cases involving removal from corporate office for cause,¹⁵ cases involving omissions from proxy statements of material information bearing on managerial competence and integrity,¹⁶ and cases involving professional disqualification.¹⁷ This Article explores the advantages—and shortcomings—of the methods the courts have used in these situations to conduct the substantial-unfitness inquiry. It then examines the experience of litigants under a statute with language and purposes similar to the Remedies Act—the British Company Directors Disqualification Act of 1986¹⁸—to see if it may provide additional direction. The Article concludes that none of these models offers sufficient guidance for determining whether and when an American executive is substantially unfit to hold high corporate office. It then proposes a seven-part test to aid federal courts in making that determination. The test requires a court to examine (1) the magnitude, or "egregiousness," of the underlying violation; (2) the defendant's previous violations of the securities laws, if any,

A QUESTION OF CHARACTER: A LIFE OF JOHN F. KENNEDY 413-21 (1991) (assessing the effect of Kennedy's personal values on his ability to lead the country).

13. See Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1482, 1483, 1491 (1984) (noting that business decisionmaking seldom involves the type of linear thinking familiar to lawyers and judges).

14. See, e.g., DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS* 6-7 & nn.20-22 (2d ed. 1988) (explaining that corporate executives have specialized expertise, which judges do not share, in dealing with business risks); see also *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 999 (1988) (plurality opinion) ("[C]ourts are generally less competent than employers to restructure business practices, and unless mandated to do so by Congress they should not attempt it." (quoting *Furnco Constr. Corp. v. Waters*, 438 U.S. 567, 578 (1978))).

15. See *infra* notes 34-39 and accompanying text.

16. See *infra* notes 40-48 and accompanying text.

17. See *infra* notes 49-63 and accompanying text.

18. See *infra* notes 64-73 and accompanying text.

and any other breaches of fiduciary duty as a corporate officer or director; (3) the role of the defendant in the underlying securities-law violation; (4) the degree of the defendant's scienter in connection with the violation; (5) the defendant's personal gain, if any, from the underlying violation; (6) the likelihood of renewed misconduct; and (7) the defendant's appreciation of the duties of a corporate executive.

I. THE ORIGINS OF THE REMEDIES ACT

The Remedies Act traces its origins to the 1987 report of the National Commission on Fraudulent Reporting (Treadway Commission),¹⁹ which recommended, among many other items, that "the SEC . . . seek [congressional] authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company."²⁰ Following this recommendation, the SEC initiated discussions with congressional officials early in 1988.

In February 1989 Representative John Dingell introduced the Securities Law Enforcement Remedies Act of 1989,²¹ which sought to implement the Treadway Commission's recommendations. The proposed statute authorized federal courts to impose executive suspension and bar orders on defendants found to have violated any provision of the federal securities laws.²² It also authorized the SEC to enter executive suspension and bar orders in administrative proceedings brought under section 15(c)(4) of the 1934 Act.²³

As originally introduced, the Remedies Act contained no standard by which courts were to determine whether to impose an executive suspension or bar order.²⁴ This omission, and other problems with the bill, led the American Bar Association (ABA), through its Section on Business Law, to oppose passage of the bill.²⁵ After Richard Breeden became

19. James Treadway, Jr., a former commissioner of the SEC, chaired the commission. *See REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING* 1 (1987).

20. *Id.* at 66. Seven years earlier, criminologists Marshall Clinard and Peter Yeager had recommended more generally that "[m]anagement officials convicted of criminally violating corporate responsibilities be prohibited from assuming similar management positions within the corporation or in another corporation for a three-year period." MARSHALL B. CLINARD & PETER C. YEAGER, *CORPORATE CRIME* 318 (1980).

21. H.R. 975, 101st Cong., 1st Sess. (1989).

22. *Id.* §§ 101, 202.

23. *Id.* § 201.

24. *See* Barnard, *supra* note 4, at 60.

25. *See Securities Laws Enforcement: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce on H.R. 975*, 101st Cong., 1st Sess. 127-32 (1989) [hereinafter *House Hearings*] (testimony of attorney Richard Phillips); Letter from Jean Allard, Section Chair, American Bar Association Section on Business Law, to

SEC chairman in October 1989, the Commission proposed amendments to the original bill that were designed to address some of the critics' concerns. The amended bill narrowed the suspension and bar provisions by deleting the SEC's authority to impose executive suspension or bar orders on its own and by limiting the bill's application in litigated matters to instances of "scienter-based fraud."²⁶ The Commission's proposed amendments, however, made no mention of "substantial unfitness" or any other standard for federal courts to rely on in determining when to impose a suspension or bar order.

After hearing arguments from the ABA and others that the SEC should have to show at least some nexus between the defendant's immediate misconduct and the need for a suspension or bar order, and that some kind of unfitness standard was necessary to ensure fairness in the application of the Remedies Act,²⁷ both the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce added a "substantial unfitness" provision to the bill during markup.²⁸ But the committees never discussed in recorded session the meaning of substantial unfitness.

The policy behind the Remedies Act is simple: barring a defendant from future service as a corporate officer or director is an expeditious mechanism, short of incarceration, for removing him from the temptation and the likelihood of renewed misconduct.²⁹ Like other forms of professional disqualification, Remedies Act orders serve the remedial goal of incapacitation. Incapacitation is thought to be a highly effective means of controlling business-centered misconduct.³⁰

The suspension and bar provisions of the Remedies Act serve other remedial goals as well. A Remedies Act order functions not only as a

the Hon. Donald W. Riegle, Jr., Chairman, Committee on Banking, Housing, and Urban Affairs, 11-24 (May 18, 1990) (on file with the *North Carolina Law Review*).

26. *The Securities Law Enforcement Remedies Act of 1989: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs on S. 647*, 101st Cong., 1st Sess. 62 (1990) [hereinafter *Senate Hearings*] (statement of Richard C. Breeden). The SEC's revised version of S. 647 was submitted to the Senate on February 9, 1990.

27. See Barnard, *supra* note 4, at 60-61; Letter from Jean Allard, *supra* note 25, at 69-71.

28. See S. REP. NO. 337, 101st Cong., 2d Sess. 3-4 (1990); H.R. REP. NO. 616, 101st Cong., 2d Sess. 28-29 (1990), reprinted in 1990 U.S.C.C.A.N. 1379, 1395-96.

29. As I have noted before, one of the advantages of the Remedies Act over criminal prosecution is that in criminal cases the SEC must cede authority to the Department of Justice. In civil cases, such as those to which the Remedies Act applies, prosecutorial discretion remains with the Commission. Barnard, *supra* note 4, at 77. Another obvious attraction is the lower burden of proof required to prove wrongdoing.

30. John Braithwaite & Gilbert Geis, *On Theory and Action for Corporate Crime Control*, 28 CRIME & DELINQ. 292, 305-08 (1982).

specific deterrent to the defendant, but also as a general deterrent to others within her organization and in the business community.³¹ Because it impairs the defendant's future employment opportunities, it serves as a monetary penalty, even for those defendants who, for whatever reasons, have no present ability to pay a substantial fine.³² "It also presents a means of extracting a fine in those instances where corporate indemnification would reimburse executives for judicially-imposed fines."³³

II. SOURCES OF STANDARDS FOR EXECUTIVE UNFITNESS

Courts have often faced issues similar to those raised by the substantial-unfitness provision of the Remedies Act. In each of the following four scenarios, courts have been asked to consider—either explicitly or implicitly—whether the defendant's conduct rendered him unfit to serve in a significant position of trust and confidence.

A. *The Removal-from-Office-for-Cause Cases*

In the comparatively rare lawsuits in which corporate officers or directors have challenged their removal from office,³⁴ courts have entered implicit findings of unfitness to serve when corporations have presented evidence of the executives' malfeasance or misconduct in office, inflexible discord on major policy issues, disobedience of board directives, harassment and uncooperativeness in the transaction of corporate business, misapplication of funds, neglect, or incompetence.³⁵ Other grounds for

31. Martin F. McDermott, Comment, *Occupational Disqualification of Corporate Executives: An Innovative Condition of Probation*, 73 J. CRIM. L. & CRIMINOLOGY 604, 616-17 (1982).

32. *Id.* at 616.

33. *Id.*

34. High-level corporate managers are typically terminable at will, subject only to the liquidated-damages provisions of their contracts. See Julia F. Siler, *Bob Schoellhorn Is Refusing to Go Quietly*, BUS. WK., Mar. 26, 1990, at 34, 34 (recounting astonishment in the business community when the long-time CEO of Abbott Laboratories sued Abbott's directors for misconduct in connection with their decision to fire him).

35. *E.g.*, NAACP of Houston Metro. Council v. NAACP, 460 F. Supp. 583, 586 (S.D. Tex. 1978) (holding that board could remove local executive secretary who failed to develop organization's membership, behaved in a "dictatorial" fashion, and was responsible for certain "irregular financial transactions"); Central Alaska Broadcasting, Inc. v. Bracale, 637 P.2d 711, 713 (Alaska 1981) (holding that board could discharge station general manager who refused to fire an employee at the board's direction); Brown v. North Ventura Rd. Dev. Co., 216 Cal. App. 2d 227, 232, 30 Cal. Rptr. 568, 571 (1963) (holding that board could remove chairman who had mismanaged a major project); Ross v. 311 North Cent. Ave. Bldg. Corp., 130 Ill. App. 2d 336, 343, 264 N.E.2d 406, 410 (1970) (holding that minority shareholders could remove officers who loaned corporate funds without adequate security to another corporation they controlled, rather than paying a dividend); Morton v. E-Z Rake, Inc., 397 N.E.2d 609,

removal, such as conduct disabling the corporation from receiving licensure,³⁶ entering into a competitive business,³⁷ or mental incapacitation,³⁸ may also exist.

Of these, however, only certain grounds for removal, such as incompetence or physical or mental incapacitation, seem sufficient to support a finding of unfitness to serve as an officer or director in *any* corporation. Other grounds for removal, such as interpersonal discord or insubordination, are often firm-specific and therefore may not be conclusive on the issue of substantial unfitness to serve in public companies marketwide.

Still other grounds for removal, such as neglect of duty or usurpation of corporate opportunity, may also be firm-specific and thus may not be helpful in resolving the substantial-unfitness question. That is, a director's failure to attend meetings or contribute constructively to the governance of a particular company where meetings have been hastily scheduled or are geographically inconvenient may not indicate a likelihood of negligence in other venues. Seizure by a director of a corporate opportunity in a particular market sector may warrant removal from the aggrieved company's board, not to mention the imposition of monetary damages, but may not warrant disqualification from leadership opportunities in other market sectors. This may be true especially when the defendant's behavior has occurred in a nonpublic company, in which controls are less formal and investors' expectations are less well-defined than in public companies.³⁹

612-13 (Ind. Ct. App. 1979) (holding that board could discharge executive vice president who failed to obey a direct order to pay certain claims); *Thisted v. Tower Management Corp.*, 147 Mont. 1, 12-13, 409 P.2d 813, 820 (1966) (holding that board could remove director who threatened to sue shareholders and "walked out" of meetings called to permit him to explain corporate plans); *Grace v. Grace Inst.*, 19 N.Y.2d 307, 315, 226 N.E.2d 531, 534, 279 N.Y.S.2d 721, 726 (1967) (holding that board could remove one of its members who had engaged in repeated and unsuccessful litigation against the corporation); *John v. John*, 153 Wis. 2d 343, 346, 450 N.W.2d 795, 798 (1989) (holding that officer/director may be removed upon showing of "gross misconduct," "lying to the board of directors, . . . deception and disobedience of the board of directors, waste, and mismanagement").

36. *Cf. Cooke v. Teleprompter Corp.*, 334 F. Supp. 467, 470-71 (S.D.N.Y. 1971) (holding that shareholders could reasonably conclude that CEO who had been convicted of bribery in the solicitation of cable franchises should be removed, lest other communities "have some reticence in dealing with" the company or "be tempted by knowledge of the conviction to exert extortionate pressures" on the company).

37. *E.g., Eckhaus v. Ma*, 635 F. Supp. 873, 874 (S.D.N.Y. 1986) (holding that discharged officer could be removed from the board for cause because he had undertaken employment with corporation's competitor); *Williams v. Queen Fisheries, Inc.*, 2 Wash. App. 691, 695, 469 P.2d 583, 586 (1970) (holding that board could remove president who misappropriated company's equipment and employees to run a competing business).

38. *See, e.g., CAL. CORP. CODE* § 302 (West 1990); *OHIO REV. CODE ANN.* § 1701.58(B)(1) (Anderson 1985 & Supp. 1991).

39. *See infra* note 48 and accompanying text.

In short, given that most removal-from-office-for-cause cases arise out of power struggles in closely held companies and also that they often involve firm-specific conduct, these cases do not, standing alone, provide adequate guidance for determining whether a defendant is substantially unfit to serve as an officer or director of any public company. In other words, behavior that would constitute grounds for removal from office for cause may be a necessary, but not a sufficient, basis for entry of a Remedies Act order.

B. *The Proxy Nondisclosure Cases*

Another possible source of authority in interpreting the substantial-unfitness provision of the Remedies Act is the line of federal proxy regulation cases in which directoral candidates and senior executives have withheld from shareholders material information that might bear on their competence and integrity and, by logical inference, their fitness to serve.⁴⁰ Courts in these cases have found the pendency of multiple lawsuits against directoral candidates,⁴¹ the existence of significant conflicts of interest on the part of directoral candidates or their agents,⁴² and a candidate's substantial criminal record⁴³ all to be material on the issue of

40. See generally Ralph C. Ferrara et al., *Disclosure of Information Bearing on Management Integrity and Competency*, 76 Nw. U. L. REV. 555, 565-605 (1981) (describing case law). Currently, proxy statements must include disclosure of certain "events" of the preceding five years that are material to an evaluation of the competency or integrity of any director, director-nominee, or executive officer. 17 C.F.R. § 229.401(f) (1991). These events include business bankruptcies, criminal convictions, entry of orders enjoining participation in the financial-services industry or other business practices, and adjudicated violations of the federal securities laws. *Id.*

41. *E.g.*, *Fry v. Trump*, 681 F. Supp. 252, 261 (D.N.J. 1988) (holding that failure to disclose 10 pending lawsuits stated a claim under SEC Rule 14a-9); *Bertoglio v. Texas Int'l Co.*, 488 F. Supp. 630, 661 (D. Del. 1980) (holding that failure to disclose prior consent decree and pending lawsuits alleging securities fraud in connection with other corporations was a material omission).

42. *E.g.*, *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787, 792 (S.D.N.Y. 1978) (holding that company should have disclosed that its investment banker had a clear conflict of interest in connection with a pending transaction, inasmuch as it might have had "an adverse affect [sic] upon the shareholders' decision on the integrity and fitness of the individual defendants to hold office"); see also *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987, 991 (2d Cir. 1988) (holding that company's failure to disclose in a merger proxy statement that director, a lawyer, had served for years as counsel to the other party's executives, was a material omission).

43. See *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895, 914 (D. Del. 1973) (holding that, when the unsavory reputation of a directoral candidate was likely to impede FCC approval of a transfer of control, failure to disclose a directoral candidate's history of bad check charges, a fugitive-from-justice warrant, and a conviction for drunk driving was a material omission under Rule 14a-9).

managerial competence and integrity.⁴⁴

Typically, upon finding that the defendant has withheld information of this sort, federal courts have required proxy resolicitation.⁴⁵ The suggestion is that had the undisclosed facts been disclosed at the outset voting shareholders might have voted "no" on the candidates because of their unacceptable conduct, rather than voting "yes" or, as often occurs, throwing their proxy ballots in the wastebasket.

The proxy nondisclosure cases, however, like the removal-from-office-for-cause cases, provide imperfect guidance for determining when an executive is substantially unfit to serve as an executive in any public company. Just because an executive's prior conduct might be material to a voting shareholder and thus properly discloseable in a proxy statement, does not mean that it should be dispositive on the issue of executive fitness. If that were the case, in every lawsuit in which material nondisclosures in proxy statements were proved, federal courts would be authorized to substitute their judgment for that of the shareholders and either delete candidates' names from the proxies before solicitation or remove already-elected directors from office. Obviously, this is not what happens. Moreover, dozens of directoral candidates each year voluntarily disclose circumstances that one could construe as reflecting negatively on their personal competence and integrity,⁴⁶ but they are not for that reason automatically disqualified from seeking corporate office.

There is, in addition, the question whether information that is arguably material within the context of a single company or type of company also is material to shareholders of *any* public company. For example, a directoral candidate's criminal past may be disqualifying when it is likely to interfere with licensure,⁴⁷ but may not be in an unreg-

44. Directoral candidates are not, however, required to "confess guilt" in proxy statements to uncharged crimes. *United States v. Matthews*, 787 F.2d 38, 46-47 (2d Cir. 1986).

45. *E.g.*, *Gladwin v. Medfield Corp.*, 540 F.2d 1266, 1267-68 (5th Cir. 1976) (affirming trial court's order requiring resolicitation and a new election); *Kaufman v. Cooper Cos.*, 719 F. Supp. 174, 185-86 (S.D.N.Y. 1989) (voiding all proxies and rescheduling meeting).

46. *See, e.g.*, *REGAL INT'L INC., PROXY SOLICITATION*, Aug. 12, 1991, available in LEXIS, Fedsec Library, Proxy File, at *11 (disclosing that director had been indicted on money-laundering charges); *FIRST CAPITAL CORP., PROXY SOLICITATION*, Feb. 16, 1990, available in LEXIS, Fedsec Library, Proxy File, at *7 (director had been convicted of failing to file an expenditure report in his capacity as a public official, a misdemeanor under local law); *McFADDIN VENTURES, INC., PROXY SOLICITATION*, June 8, 1989, available in LEXIS, Fedsec Library, Proxy File, at *25 (director of merger partner had pled guilty to misdemeanor contempt of court); *GAF CORP., PROXY SOLICITATION*, Jan. 23, 1989, available in LEXIS, Fedsec Library, Proxy File, at *115 (vice chairman had been indicted for conspiracy, stock price manipulation, securities fraud, and wire fraud).

47. *E.g.*, *Chris-Craft*, 354 F. Supp. at 914 (holding that a criminal record was material because it could result in revocation of company's FCC license).

ulated industry. A directoral candidate's alleged misconduct within the confines of a family-owned business or other nonpublic company may not disqualify him (or suggest that he should be disqualified) from serving as an officer or director of a public company.⁴⁸

In short, the proxy nondisclosure cases, while instructive on the types of behavior that may evidence substantial unfitness, do not define substantial unfitness. Courts would surely overreach were they to find that any behavior required by the federal proxy regulations to be disclosed in a later-dated proxy statement provides sufficient grounds for imposition of a Remedies Act order.

C. *The Professional Disqualification Cases*

Another possible source of authority on the question of substantial unfitness is the line of professional disqualification cases involving lawyers, physicians, and others. Typical professional licensure statutes provide for license revocation in cases of "illegal conduct," "habitually negligent practice," "dishonorable conduct," or "fraudulent or dishonest conduct."⁴⁹ The body of less than entirely satisfying law that has developed around these statutes demonstrates the uncertainty that often accompanies their application. For example, professionals have successfully challenged statutes permitting disqualification for "gross negligence" and "misconduct" on the grounds that they are void for vagueness.⁵⁰ Other professionals, however, have lost when they argued that such disqualifying standards as "unprofessional conduct,"⁵¹ "dishonorable conduct,"⁵² or "bad moral character"⁵³ are unconstitutional. All of these statutes, however, share a feature not present in the Remedies Act: initial application in whole or in part by peer professionals who are assumed to be knowledgeable about the customs and practices of

48. *E.g.*, *GAF Corp. v. Heyman*, 724 F.2d 727, 742-43 (2d Cir. 1983) ("[Behavior] involving management of a public corporation should be considered more important to voting stockholders than [behavior within a family business.]").

49. RANDOLPH P. REAVES, *THE LAW OF PROFESSIONAL LICENSING AND CERTIFICATION* 208 (1984).

50. *H & V Eng'g, Inc. v. Board of Professional Eng'rs*, 113 Idaho 646, 649-51, 747 P.2d 55, 58-60 (1987) (stating that "[d]isciplinary standards cannot be kept secret from the professionals or the courts" and that "[w]ithout clearly articulated standards as a backdrop against which the court can review discipline, the judicial function is reduced to serving as a rubber stamp for the [Disciplinary] Board's action").

51. *Chastek v. Anderson*, 83 Ill. 2d 502, 509, 416 N.E.2d 247, 251 (1981) (holding that such terms are "susceptible to common understanding by members of the profession").

52. *Duncan v. Missouri Bd. for Architects*, 744 S.W.2d 524, 532 (Mo. Ct. App. 1988) (citing *State ex rel. Lentine v. State Bd. of Health*, 334 Mo. 220, 234, 65 S.W.2d 943, 949 (1933); *Holmes v. Missouri Dental Bd.*, 703 S.W.2d 11, 12 (Mo. Ct. App. 1985)).

53. *Id.*

their profession as well as the standards of conduct—often embodied in a written code—to which members of their profession are to be held.

Other than generalized standards of care and loyalty,⁵⁴ there are no such agreed-upon standards of conduct for corporate officers and directors, nor any recognized peer-reviewing bodies to construe them. The National Association of Corporate Directors, a voluntary membership organization, does not “disqualify” from office those applicants who fail to meet its membership standards. Neither does the Conference Board, the Young Presidents’ Organization, or the Business Roundtable.

Some professional disqualification statutes are straightforward in describing the circumstances that give rise to disqualification. Often states automatically disqualify professionals found guilty of a felony, for example.⁵⁵ There are no such rules, however, for corporate executives. Thus, we find corporate boards appointing and reappointing managers who have been found guilty of tax evasion,⁵⁶ assault, drunk driving, and other “personal” crimes,⁵⁷ and even forgery and embezzlement from the companies they serve in a fiduciary capacity.⁵⁸ What differentiates these executives from their (disqualified) professional brethren is not their moral purity but their ability to generate value for their shareholders.

Federal disqualification statutes—even those administered by the SEC—similarly fail to suggest a workable standard for determining when corporate executives are substantially unfit. Registered brokers may have their registrations suspended or revoked if they have “willfully violated” the securities laws and the suspension or revocation is “in the public interest.”⁵⁹ In these cases, however, the SEC, not a federal court, makes the initial decision to suspend or revoke the defendant’s license. Like state disciplinary panels for physicians and lawyers, the SEC is believed to have special expertise in reviewing claims of unfitness among

54. See, e.g., REVISED MODEL BUSINESS CORP. ACT § 8.30 (1991).

55. E.g., N.Y. JUD. LAW § 90(4) (McKinney 1983) (providing for automatic disbarment when an attorney is convicted of a felony).

56. See, e.g., Phyllis Furman, *Albert Nipon's in Basic Black Again—Dress Company Fashions a Turnaround*, CRAIN'S N.Y. BUS., Nov. 14, 1988, at 3, available in LEXIS, Nexis Library, NYBus File (reporting that CEO of Albert Nipon, Inc. returned to company after a 20-month imprisonment).

57. See, e.g., PETER COLLIER & DAVID HOROWITZ, *THE FORDS: AN AMERICAN EPIC* 382 (1987) (recounting the well-publicized drunk driving arrest of Henry Ford II while he was CEO of Ford Motor Co.).

58. See, e.g., DAVID MCCLINTICK, *INDECENT EXPOSURE: A TRUE STORY OF HOLLYWOOD AND WALL STREET* 311-25 (1982) (recounting the story of David Begelman, who was reinstated as president of Columbia Pictures, Inc. following disclosure that he had embezzled tens of thousands of dollars from the company).

59. 15 U.S.C. § 78o(b)(4) (1988). A similar standard applies to mutual fund managers and investment advisers. See *id.* §§ 80a-9(b), 80b-3(e).

financial professionals⁶⁰ and to appreciate the special "public interest" needs present in the financial markets.⁶¹ No one would suggest that federal courts share this special expertise or indeed that *anyone* has special expertise with respect to the issue of corporate executives' fitness to serve. The inability to define managerial fitness with precision may explain in part why so many boards have fired their CEOs in recent months⁶² or why so many substantial and respectable public companies have found themselves filing for protection under the bankruptcy statutes.⁶³

In short, the professional disqualification cases are of little direct use in deciding who is substantially unfit to serve as a corporate officer or director. Indeed, risk-prone behavior unsuited to a nonexecutive professional may be precisely the sort of behavior investors seek when their company is facing new market challenges.

D. The Company Directors Disqualification Act

Another possible source of authority that appears at first glance to be quite directly on point is a line of English cases decided under the Company Directors Disqualification Act of 1986, which permits courts in the United Kingdom to suspend or bar corporate executives whom they find to be "unfit to be concerned in the management of a company."⁶⁴ Under a predecessor to this statute the late Robert Maxwell, as

60. See *Hanly v. SEC*, 415 F.2d 589, 598 (2d Cir. 1969).

61. The "public interest" standard has withstood challenges that it is void for vagueness, in part because courts have found that the SEC is singularly well situated to determine what the public interest requires. See *Dirks v. SEC*, 802 F.2d 1468, 1471 (D.C. Cir. 1986).

62. See Jim Bartimo & Karen Blumenthal, *Compag's Canion is Unexpected Casualty of the Brutal Personal-Computer Wars*, WALL ST. J., Oct. 28, 1991, at B1; Joann S. Lublin, *More Chief Executives Are Being Forced Out by Tougher Boards*, WALL ST. J., June 6, 1991, at A1; Amal K. Naj, *Hennessy Is Retiring at Allied-Signal Inc., Sooner Than Expected*, WALL ST. J., June 27, 1991, at A1.

63. These companies include, for example, Greyhound, Eastern Airlines, TWA, Southland Corp., Revco Drugs, Federated Department Stores, Allied Stores, Macy's, Drexel Burnham Lambert, and Circle K. Amanda Bennett & Joann S. Lublin, *Increasing Turnover at the Top Sends Many Executives' Careers into Limbo*, WALL ST. J., Apr. 13, 1992, at B1.

64. 7(2) HALSBURY'S LAWS OF ENGLAND para. 2113 (4th ed. Reissue 1988). The act in full provides:

The court must make a disqualification order against a person in any case where, on an application for this purpose, the court is satisfied (1) that he is or has been a director of a company which has at any time become insolvent, whether while he was a director or subsequently, and (2) that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or other companies, makes him unfit to be concerned in the management of a company.

The minimum period of disqualification which may be imposed under these provisions is two years, and the maximum period which may be imposed is 15 years.

Id. (footnotes omitted).

a result of the failure of his Pergamon Press, was found in 1971 to be "a person who [cannot] be relied on to exercise proper stewardship of a publicly quoted company."⁶⁵

The Disqualification Act is enforced by the British Department of Trade and Industry (DTI), which receives referrals from receivers in insolvency proceedings. In 1989 DTI authorized court action in 440 of the 3,234 disqualification referrals it received.⁶⁶ British courts disqualified 303 directors that year, causing some observers to lament that an increasing number of unfit directors was escaping the public's notice.⁶⁷

Applying the "unfit to be concerned in the management of a company" standard, British courts have found unfitness in cases in which the defendant traded consecutively through several insolvent companies that had failed to pay their corporate tax obligations;⁶⁸ in which the defendant traded simultaneously through several insolvent companies, one of which was undercapitalized from the beginning, and paid himself excessive compensation, rendering the companies unable to pay their corporate taxes;⁶⁹ and in which the defendant was the sole director of four companies, all of which were undercapitalized from the beginning, none of which filed timely financial reports, and all of which became insolvent within a five-year period, leaving their corporate taxes unpaid.⁷⁰ Courts have disqualified directors whose involvement in a company's failure has been no more than "peripheral,"⁷¹ and even directors who personally lost substantial funds as a result of the failure.⁷² Courts considering disqualification orders may review only the conduct that gave rise to the underlying insolvency, and may not consider extrinsic evidence of other business

65. Peter J. Boyer, *Maxwell's Silver Hammer*, VANITY FAIR, June 1991, at 112, 180. Maxwell's alleged looting 20 years later of the pension funds at Mirror Group and of corporate funds at Maxwell Communication, Inc. suggests that the Pergamon disqualification order was both valid and prescient. See, e.g., Nicholas Bray, *Securities Lending in UK Dealt Blow by Maxwell Affair*, WALL ST. J., Dec. 9, 1991, at A10.

66. *Receivers Act*, DAILY TELEGRAPH (London), Oct. 15, 1990, at 27.

67. Roland Gribben, *Reforms Fail to Weed out the 'Rogues'*, DAILY TELEGRAPH (London), Sept. 24, 1990, at 27.

68. *In re Lo-Line Elec. Motors Ltd.*, [1988] 1 Ch. 477, 491.

69. *In re Stanford Servs. Ltd.*, [1987] BCLC 607, 613.

70. *In re Churchill Hotel (Plymouth) Ltd.*, [1988] BCLC 341. "To reach a finding of unfitness the court must be satisfied that the director has been guilty of a serious failure or serious failures, whether deliberately or through incompetence, to perform those duties of a director which are attendant on the privilege of trading through companies with limited liability." 7(2) HALSBURY'S LAWS OF ENGLAND para. 2114 n.3 (4th ed. Reissue 1988). Misconduct in any capacity other than that of a director may be disregarded. *Lo-Line*, [1988] 1 Ch. at 485.

71. *In re Majestic Recording Studios Ltd.*, [1989] BCLC 1, 5-6.

72. *In re Sevenoaks Stationers (Retail) Ltd.*, [1991] Ch. 164, 179-80.

misconduct.⁷³

The problem with using these cases as a model to determine substantial unfitness under the Remedies Act is that the Disqualification Act is triggered by corporate insolvency, not by managerial misconduct that may fall short of business failure, and is largely a feature of British national revenue policy rather than of any policy relating to the protection of investors. That is, the Disqualification Act exists primarily to deter corporate managers from failing to honor their tax obligations to the Crown, not to deter them from failing to make required financial disclosures to investors under the applicable securities laws. This singular focus of the Disqualification Act and the fact-specific, small-company context in which most of the recent disqualification cases have been decided severely limit the utility of these cases in construing the substantial-unfitness standard contained in the Remedies Act.

III. A PRELIMINARY PRESCRIPTION FOR APPLYING THE SUBSTANTIAL-UNFITNESS PROVISION OF THE REMEDIES ACT

How, then, should federal courts approach the substantial-unfitness question? A simple answer is that they should do so with great forbearance. At a minimum, the power to bar someone from significant opportunities for employment should require proof by clear and convincing evidence that such a sanction is necessary.⁷⁴ And even assuming the

73. *Id.* at 177 (holding that period of disqualification should be based solely upon evidence submitted in connection with a specific insolvency).

74. *See* *Whitney v. SEC*, 604 F.2d 676, 681 (D.C. Cir. 1979) (requiring that evidence of need to suspend broker's license be clear and convincing); *Ferris v. Turlington*, 510 So. 2d 292, 294 (Fla. 1987) (requiring that evidence of need to revoke teacher's license be clear and convincing). The law has long recognized that assertions of unfitness for employment carry serious consequences for the subject. For example, such assertions, if false, constitute defamation per se, excusing the plaintiff from pleading or proving special damages. *See* *Abbott v. United Venture Capital, Inc.*, 718 F. Supp. 823, 827 (D. Nev. 1988) (holding libelous per se the publication of allegations, later withdrawn, that a lawyer engaged in multiple securities violations). In this sense, allegations of unfitness are much like allegations of common-law fraud, which, because of the stigma they impose on the defendant, must be proved by clear and convincing evidence. *E.g.*, *Addington v. Texas*, 441 U.S. 418, 424 (1979); *Woodby v. INS*, 385 U.S. 276, 285 n.18 (1966). In contrast, the standard of proof on the issue whether the defendant violated the underlying antifraud statute is only a preponderance of the evidence. *See* *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389-91 (1983) (requiring lower court to apply preponderance-of-the-evidence standard in a private action for violation of Rule 10b-5); *Steadman v. SEC*, 450 U.S. 91, 102 (1981) (requiring proof that investment adviser violated antifraud provisions to meet only the preponderance-of-the-evidence standard); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943) (requiring lower court to apply preponderance-of-the-evidence standard in SEC injunctive action for violation of § 17(a) of the 1933 Act).

standard of proof is high, one must also consider what sorts of evidence might be probative on the issue of substantial unfitness to serve.

A. What Conduct Should Be Considered?

An initial question is whether the "conduct" of the defendant that the court must review to reach its determination on the substantial-unfitness question should be limited to that shown by the SEC in connection with the underlying securities law violation, or whether that conduct may also encompass other activities preceding and postdating the violation. This question—whether the court in the "remedies phase" of the trial should consider evidence extrinsic to that adduced in the "merits phase"—is familiar to criminal defense lawyers. In the sentencing phase of criminal cases, prosecutors often present extrinsic evidence of "other crimes" and the defendant may challenge that evidence in a so-called *Fatico* hearing,⁷⁵ as occurred, for example, in Michael Milken's case before Judge Kimba Wood in October 1990.⁷⁶

1. Extrinsic Evidence of Misconduct

The SEC undoubtedly will argue that extrinsic evidence is fair game for the court in determining whether a defendant is substantially unfit to serve as an officer or director of a public company. After all, a primary purpose of the Remedies Act is to create new enforcement options for dealing with repeat violators of the securities laws.⁷⁷ If the court were limited to the evidence submitted in support of the government's case in chief, only those defendants found to have participated in a single "egregious" fraud would be subject to a suspension or bar order,⁷⁸ while recidivists who engage in sequential, smaller frauds would remain free to abuse their management positions again and again.

There is, however, another way to view the issue whether a court should consider extrinsic evidence in addressing the substantial-unfitness

75. See *United States v. Fatico*, 579 F.2d 707, 711-14 (2d Cir. 1978).

76. Kurt Eichenwald, *Final Chapter in Milken Inquiry*, N.Y. TIMES, Oct. 11, 1990, at D1, D6.

77. See *infra* text accompanying note 115.

78. "For example, a corporate officer who perpetrates a financial fraud on the scale of the *Equity Funding* case, having been brought to justice, should not be permitted to regain a position of corporate control." *Senate Hearings*, *supra* note 26, at 30 (statement of Richard C. Breeden). *Equity Funding* involved a decade-long two-billion dollar insurance fraud scheme in which corporate employees falsified thousands of records in order to create the appearance of a successful enterprise; the ultimate loss to investors was estimated at tens of millions of dollars. See RAYMOND L. DIRKS & LEONARD GROSS, *THE GREAT WALL STREET SCANDAL* 11 (1974); RONALD L. SOBLE & ROBERT E. DALLOS, *THE IMPOSSIBLE DREAM: THE EQUITY FUNDING STORY* 278 (1975).

question. The justification for admitting extrinsic evidence during the sentencing phase of a criminal case is that a court's responsibility for sentencing historically has implicated broader considerations than those applicable to the finding of guilt or innocence.⁷⁹ These considerations include a societal interest in retribution and deterrence. Courts also have recognized a need to individualize sentences—to tailor them to the defendant as well as to the crime—and this view often has been cited to justify relaxing the rules of evidence and permitting broad-ranging inquiry into every aspect of the defendant's life.⁸⁰ These considerations need not apply in civil cases and, indeed, may be entirely inappropriate, given that the purpose of sentencing is to impose *punishment* and punishment is constitutionally impermissible in civil proceedings.⁸¹

This latter view, however persuasive, is unlikely to prevail. Given the policies underlying the Remedies Act, courts are likely to adopt the government's view and liberally entertain extrinsic evidence of wrongdoing in the remedies phase of the trial.⁸² This is not inappropriate because (1) the information is relevant to the inquiry at hand—that is, whether the defendant has “a propensity to abuse a position of corporate trust,”⁸³ and (2) the suspension-or-bar power is available only in SEC enforcement proceedings and not in private damages actions.⁸⁴ Thus, the public-interest considerations relevant to the entry of a suspension or bar order are similar to those attendant to the imposition of a criminal sentence,⁸⁵ and warrant a broad inquiry into the defendant's overall behavior.

79. *Williams v. New York*, 337 U.S. 241, 247 (1949) (“A sentencing judge, however, is not confined to the narrow issue of guilt. His task within fixed statutory or constitutional limits is to determine the type and extent of punishment after the issue of guilt has been determined.”).

80. *Id.*

81. *Kennedy v. Mendoza-Martinez*, 372 U.S. 144, 167 (1963); *see also Hecht Co. v. Bowles*, 321 U.S. 321, 329 (1944) (stating that injunctive relief is “designed to deter, not to punish”).

82. *See, e.g., SEC v. Thomasson Panhandle Co.*, 145 F.2d 408, 411 (10th Cir. 1944) (approving admission of evidence of scheme post-dating allegations in underlying cause of action “for the purpose of proving the allegation of the complaint that the defendant[] would continue to engage in the acts and practices set forth in the complaint”); *SEC v. Everest Management Corp.*, 466 F. Supp. 167, 176 (S.D.N.Y. 1979) (considering defendant's conduct in an entirely unrelated matter, “insofar as it reflect[ed] [the defendant's] pronounced tendency to operate outside the recognized bounds of his profession and the law”).

83. *Senate Hearings*, *supra* note 26, at 30 (statement of Richard C. Breeden).

84. 15 U.S.C.S. § 77t (Law. Co-op. 1991); *id.* § 78u-1 (Law. Co-op. Supp. 1991).

85. *See* 1 MARC I. STEINBERG & RALPH C. FERRARA, *SECURITIES PRACTICE: FEDERAL & STATE ENFORCEMENT* § 5.03 (1991).

2. Hearsay Allegations

Assuming extrinsic evidence is admissible on the substantial-unfitness question, another, more troublesome, question now arises. In criminal cases, the court during the sentencing phase may consider not only extrinsic evidence but also hearsay evidence.⁸⁶ Thus, courts have entertained hearsay references to the defendant's prior unindicted crimes,⁸⁷ affiliations with organized crime,⁸⁸ and unsubstantiated acts of mayhem⁸⁹ as part of the sentencing equation. This practice has been justified on the grounds that no jury is involved and that the sentencing inquiry is not a "fact finding" inquiry but a predictive one, thus permitting a more flexible application of the rules of evidence.

The practice of considering hearsay evidence, however, should not extend to cases in which the SEC seeks entry of a Remedies Act order, for two reasons. First, Congress has not indicated, as it has in the case of criminal sentencing,⁹⁰ its approval of such a practice. Second, civil enforcement actions seldom will require the court to consider anonymous allegations by government informants, as may occur in criminal cases. Federal courts hearing cases brought under the Remedies Act should not be permitted to consider hearsay testimony—on the issue of substantial unfitness or otherwise—except as the Federal Rules of Evidence expressly, and narrowly, permit.⁹¹

3. The Range of Wrongs to Be Considered

Assuming the court entertains evidence of managerial misconduct

86. Not all of the strict procedural safeguards and evidentiary limitations of a criminal trial are required at sentencing. *Williams v. New York*, 337 U.S. 241, 247, 250 (1949). A trial judge making a sentencing determination may "appropriately conduct an inquiry broad in scope, largely unlimited either as to the kind of information he may consider, or the source from which it may come." *United States v. Tucker*, 404 U.S. 443, 446 (1972).

87. *E.g.*, *United States v. Bonnet*, 769 F.2d 68, 70 (2d Cir. 1985) (upholding district court's consideration of presentence report, which included allegation that defendant had been involved in a scheme to exchange stolen cars for narcotics, even though government conceded it had no witnesses who could testify to this).

88. *United States v. Napolitano*, 761 F.2d 135, 139 (2d Cir.) (upholding district court's consideration of testimony of government witnesses who recounted allegations by six confidential informants that defendant "was associated with a known crime family figure as a trusted associate and collector for him"), *cert. denied*, 474 U.S. 842 (1985).

89. *E.g.*, *United States v. Carmona*, 873 F.2d 569, 575 (2d Cir. 1989) (upholding district court's consideration of hearsay testimony that defendant was drug organization's chief "enforcer" and contract killer).

90. 18 U.S.C. § 3661 (1988) ("No limitation shall be placed on the information concerning the background, character, and conduct of a person convicted of an offense which a court of the United States may receive and consider for the purpose of imposing an appropriate sentence.").

91. *See* FED. R. EVID. 801-06.

other than that involved in the underlying violation of the securities laws, *excluding hearsay*, yet a third question arises: Should that evidence be limited to proof of financial misconduct, or may it include evidence of other forms of managerial misconduct, such as violations of the equal employment laws or environmental regulations? What conduct is relevant to determining whether an executive is substantially unfit to serve? It is conceivable that, in enacting the Remedies Act, Congress intended to encourage judicial examination of all aspects of an executive's work, including competence, diligence, and command of market share, in addition to previous violations of the securities laws. It seems unlikely, but the legislative history is silent on this issue. A more reasonable interpretation of the statutory language, given its context, would limit the field of inquiry to other violations of the federal securities laws, violations of related state securities laws, and what may loosely be described as "managerial misconduct," including breaches of fiduciary duties to investors and creditors.

B. The Enforcement Injunction Versus the Remedies Act Order

Long before the enactment of the Remedies Act, federal courts hearing SEC enforcement actions often entered orders against defendants found to have violated the securities laws, requiring them to disgorge their ill-gotten profits⁹² and enjoining them from engaging in specific future misconduct.⁹³ The test for entering this second, "obey the law" type of injunction is whether, under all the circumstances, "there is a reasonable likelihood that the wrong will be repeated."⁹⁴

The Remedies Act in no way impairs courts' authority to continue to enter these sorts of enforcement injunctions, when the "likelihood of

92. *E.g.*, SEC v. *Materia*, 745 F.2d 197, 201-02 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); SEC v. *Tome*, 638 F. Supp. 596, 626-28 (S.D.N.Y. 1986).

93. *E.g.*, *Materia*, 745 F.2d at 201 (enjoining defendant from insider trading); SEC v. *Champion Sports Management, Inc.*, 599 F. Supp. 527, 534 (S.D.N.Y. 1984) (enjoining defendant from future violations of Rule 10b-5); SEC v. *Scott*, 565 F. Supp. 1513, 1536 (S.D.N.Y. 1983) (same), *aff'd sub nom.* SEC v. *Cayman Islands Reins. Corp.*, 734 F.2d 118, 119 (2d Cir. 1984); SEC v. *Dimensional Entertainment Corp.*, 518 F. Supp. 773, 778 (S.D.N.Y. 1981) (enjoining defendant from violating registration provisions of the 1933 Act).

94. SEC v. *Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972); *see also* SEC v. *Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979) ("[T]he test for injunctive relief is 'whether the defendant's past conduct indicates . . . that there is a reasonable likelihood of further violation in the future.'"). Recently, some courts have become quite stringent in the level of proof they require to support entry of an injunction. *See, e.g.*, SEC v. *John Adams Trust Corp.*, 697 F. Supp. 573, 577 (D. Mass. 1988) (SEC must present "positive proof of a realistic likelihood that past wrongdoing will recur" and also demonstrate that recurrent violations are a "relatively imminent threat" (citing SEC v. *Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977)); SEC v. *Dimensional Entertainment Corp.*, 493 F. Supp. 1270, 1278 (S.D.N.Y. 1980)).

recurrence" standard is met.⁹⁵ Rather, the Remedies Act has given federal courts a new remedy, but it has conditioned that remedy on a showing ("substantial unfitness") above and beyond the lesser standard ("likelihood of recurrence") that is required to support an enforcement injunction. It is therefore important to emphasize that a defendant who may legitimately be subject to an injunction against specific forms of misconduct is not necessarily subject to a suspension or bar order under the Remedies Act. That is, it may be appropriate for a court to enjoin specific future acts, or even to enter a corporation-specific suspension or bar order,⁹⁶ but it may be inappropriate on the same set of facts to conclude that the defendant is substantially unfit to serve as an executive of *any* public company. Consider the following example.

The SEC recently alleged that, during 1986 and 1987, the chief financial officer, chief accounting officer, chief operating officer, and chairman of the board of Thortec International, Inc. doctored the company's financial statements so as to overstate revenue by \$8.4 million.⁹⁷ These allegations are similar to those made in one of the SEC's first "test cases" under the Remedies Act.⁹⁸ In settling the Thortec charges, the defendants consented to an injunction prohibiting them from engaging in future violations of specified securities laws in any setting.⁹⁹ In similar cases, defendants have agreed to injunctions prohibiting them from serving as officers or directors of the specific companies in which their misconduct occurred.¹⁰⁰ Some have even consented to comprehensive orders en-

95. See H.R. REP. NO. 616, 101st Cong., 2d Sess. 28 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379, 1395. "The Committee emphasizes that specifying this particular type of ancillary relief in the legislation should not be construed as restricting the authority of the federal courts to impose any form of equitable relief for a violation of the securities laws." *Id.* "By specifying this particular type of ancillary relief, the section does not restrict the court's inherent equitable authority." *Id.* at 31, *reprinted in* 1990 U.S.C.C.A.N. at 1398.

96. See Barnard, *supra* note 4, at 51-53.

97. *Ex-Engineering Execs Settle Charges They Overstated Firm's Revenues, Income*, 22 Sec. Reg. & L. Rep. (BNA) 849, 849 (June 1, 1990).

98. See David Sterns, Litig. Release No. 12,802, 1991 SEC LEXIS 502, at *1-3, 1991 WL 296465 (S.E.C.) at *2-4 (Mar. 11, 1991).

99. Richard H. Towle, Litig. Release No. 12,484, [1987-1991 Accounting & Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,727, at 63,289, 63,289, 63,290 (May 24, 1990) (defendants agreed not to aid or abet violations of § 13 of the Exchange Act, and one defendant, the corporate chief financial officer, agreed not to violate § 17(a)(2) or § 17(a)(3) of the Securities Act).

100. *E.g.*, Florafax Int'l, Inc., Litig. Release No. 10,617, [1987-1991 Accounting & Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,444, at 63,161, 63,162-63 (Nov. 27, 1984) (CEO agreed to resign and refrain from serving for three years); American Commonwealth Fin. Corp., Litig. Release No. 8561, 1978 SEC LEXIS 557, at *1, 1978 WL 19925 (S.E.C.) at *1-2 (Oct. 11, 1978) (defendant, CEO and director, agreed to resign and refrain from serving as officer or director); Penn Cent., Litig. Release No. 8378, 1978 SEC LEXIS 1723, at *1, 1978 WL 20740 (S.E.C.) at *1 (Apr. 21, 1978) (defendant

joining them from serving as an officer or director of any public company.¹⁰¹

Assuming the Thortec defendants had litigated, rather than settled, the SEC's complaint, it is entirely possible that a federal judge hearing the case would have entered an enforcement injunction identical to that agreed to in settlement. This remedy would permit the defendants, on pain of contempt were they to violate the injunction's terms, to continue working in their existing environment or elsewhere.

Alternatively, the court could have entered a corporation-specific injunction, forcing the defendants to leave the scene of their prior misconduct either temporarily or permanently,¹⁰² but leaving them free to seek work as executives in those public companies willing to hire and supervise them.¹⁰³ In any event, the full force of the Remedies Act "death penalty" provision, foreclosing the defendant's most restorative job opportunities, might not be required to achieve the Act's stated objective of investor protection.

In pre-Remedies Act cases, federal courts were admonished to tailor each injunction so as to "restrain no more than what is reasonably required to accomplish its ends."¹⁰⁴ This same sense of restraint—and a rule of thumb counseling courts to apply the least invasive remedy possi-

agreed not to become a director, officer, employee, or consultant to any of the Penn Central "complex of companies," presumably for life).

101. Charles W. Anshen, Litig. Release No. 11,618, 1987 SEC LEXIS 3094, at *1, 1987 WL 110215 (S.E.C.) at *1-2 (Dec. 2, 1987) (barring defendant from serving as an officer or director of a public company for five years); Wallace C. Sparkman, Litig. Release No. 11,532, 1987 SEC LEXIS 3795, at *2, 1987 WL 113537 (S.E.C.) at *2 (Sept. 3, 1987) (barring defendant from serving as either a director or an officer of a public company for four years); Gulf Resources, Inc., Litig. Release 10,291, 1984 SEC LEXIS 2168, at *1, 1984 WL 50519 (S.E.C.) at *1-2 (Feb. 21, 1984) (prohibiting one defendant from becoming or acting as an officer, director, or control person of any public company absent Commission permission); Frederix P. DeVeau, Litig. Release No. 9842, 1982 SEC LEXIS 106, at *1, 1982 WL 34335 (S.E.C.) at *1-2 (Dec. 17, 1982) (barring defendant from associating as an officer, director, control person, or consultant to any public companies until he satisfies a disgorgement order and thereafter only upon notice to the Commission); Jack M. Catain, Jr., Litig. Release No. 9129, 1980 SEC LEXIS 1123, at *3, 1980 WL 21849 (S.E.C.) at *3 (July 8, 1980) (barring defendant from serving as an officer or director of a public company absent court approval); Sheldon L. Hart, Litig. Release No. 9080, 1980 SEC LEXIS 1526, at *1, 1980 WL 26886 (S.E.C.) at *1-2 (May 9, 1980) (barring defendant from being a director or, under certain circumstances, an officer of a public company unless that company has and maintains an audit committee of the board).

102. Such an order would be proper as a form of ancillary relief. SEC v. Techni-Culture, Inc., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,501, at 95,758, 95,759 (Apr. 2, 1974).

103. Remember that under the proxy rules shareholders also would be entitled to know about the existence of the injunction, thus raising the likelihood that the defendants' conduct would be closely monitored. See *supra* note 40.

104. Consolidation Coal Co. v. Disabled Miners, 442 F.2d 1261, 1267 (4th Cir.) ("[T]he nature and extent of the relief granted should not exceed that necessary to adequately protect

ble—should extend to consideration of executive suspension or bar orders under the Remedies Act. Given the alternative remedies already available, federal courts should turn to this extraordinary form of relief only as a last resort.

This is not to say that hard-core securities-law violators should be immune from imposition of a Remedies Act order. I merely urge caution against the too-easy application of the Act's powerful disqualification provision, especially since this type of sanction inherently invites overuse.¹⁰⁵

C. *The Substance of the Inquiry*

Bearing in mind the limits on the scope of inquiry discussed above,¹⁰⁶ a federal court should consider seven issues before it can feel confident in making a finding of substantial unfitness. As a threshold question, the court should ask whether the defendant's conduct was either "egregious" or "chronic," because these are the only two circumstances under which Congress anticipated the Remedies Act order would be available.

1. The "Egregiousness" of the Underlying Violation

In lobbying for the Remedies Act, both SEC Chairman Richard Breeden and his predecessor, David Ruder, assured Congress that the Commission would seek executive suspension and bar orders only in cases of "egregious" misconduct or of repeated violations of the securities laws.¹⁰⁷ Inevitably, however, the SEC and defendants will differ about what conduct qualifies as "egregious." Thus, federal courts may have to adopt at least informal guidelines to determine whether the SEC has satisfied this necessary precondition—a showing of misconduct beyond mere liability—for initiating the substantial-unfitness inquiry. This is not an unfamiliar process. In deciding whether to enter enforcement injunctions in pre-Remedies Act cases, courts often looked to the magni-

the public interest."), *cert. denied*, 404 U.S. 911 (1971); *SEC v. Paro*, 468 F. Supp. 635, 650 (N.D.N.Y. 1979).

105. See *infra* note 167 and accompanying text.

106. See *supra* part III.A.2.

107. *Senate Hearings, supra* note 26, at 29-30 (statement of Richard C. Breeden); *Hearings on a Bill to Amend Federal Securities Laws in Order to Provide Additional Enforcement Remedies for Violation of these Laws: H.R. 975 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 1st Sess. 65 (1989) (statement of David S. Ruder, Chairman of the SEC); *Hearings on the Recommendations of the National Commission on Fraudulent Financial Reporting Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. 174 (1988) (statement of David S. Ruder).

tude of the underlying securities law violations.¹⁰⁸ Another analogy familiar to federal courts is the process of determining whether a defendant's conduct, in addition to supporting a finding of liability, has been sufficiently willful and wanton to support a judgment for punitive damages.¹⁰⁹

Some indicia of "egregiousness" are predictable. In considering whether a defendant is substantially unfit to serve, district courts should ask with respect to the SEC's case-in-chief these eight questions: Was the loss to investors actual, or only hypothetical?¹¹⁰ What was the amount of investors' losses, both in the aggregate and per investor? How many investors suffered losses? Did the defendant act alone or did she enlist the participation of other, less culpable actors? Did the violation occur within the confines of one enterprise, or involve several? Was the defendant's infraction an isolated action or part of a comprehensive and long-lasting scheme? What was the duration of the scheme? Finally, did the violation generate public attention (that is, was it regarded as newsworthy)? A showing under these guidelines that the defendant's actions resulted in substantial harm, both to individual victims and to the securities markets generally, could fairly bring about a finding that her conduct was "egregious." Only then should the court proceed to consider the defendant's fitness to serve as a corporate executive in the future.

In considering the egregiousness issue, federal courts could, but need not, refer to the formulas set forth in the federal sentencing guidelines for determining the "offense level" of similar behavior in a criminal context. The sentencing guidelines categorize fraud-related crimes based on such factors as the defendant's premeditation and the amount lost by defrauded complainants,¹¹¹ and then permit upward or downward adjustment based on the defendant's degree of leadership in the fraud,¹¹² the nature of the victim(s),¹¹³ and the defendant's acceptance of responsi-

108. See, e.g., *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 53-54 (7th Cir. 1972) ("These were not mere 'technical' violations of regulatory legislation, but continual and extensive violations of provisions which lie at the very heart of a remedial statute.").

109. JAMES D. GHIARDI & JOHN J. KIRCHER, *PUNITIVE DAMAGES LAW & PRACTICE* § 5.03 (1985).

110. There can be a startling difference between estimated investor losses and "proven" losses. See, e.g., DENNIS LEVINE, *INSIDE OUT: AN INSIDER'S ACCOUNT OF WALL STREET* 416-17 (1991) (noting that while prosecutors argued that Michael Milken's crimes had cost the investing public \$4-7 million, the trial judge ruled that the total investor loss was \$318,082).

111. U.S. SENTENCING COMM'N, *FEDERAL MANUAL-1992 EDITION* § 2F1.1 (1991).

112. *Id.* § 3B1.1 (permitting upward adjustment when defendant was the manager, organizer, supervisor, or leader of the scheme).

113. *Id.* § 3A1.1 (providing for upward adjustment when the defendant's victim(s) can be characterized as "vulnerable"); see, e.g., *United States v. Benskin*, 926 F.2d 562, 565-66 (6th Cir. 1991) (subjecting defendant broker who defrauded investors of over \$3.8 million to 100%

bility for the offense.¹¹⁴ Calculating a hypothetical offense level under the guidelines could serve as a benchmark in assessing the propriety of entering a Remedies Act order. A preferable and less formulaic course would require the court to consider "egregiousness" using the mosaic process described above.

2. The Defendant's "Repeat Offender" Status

An alternative threshold inquiry, when "egregiousness" may not be present, is whether the defendant is a repeat, or "chronic," securities-law violator. In pre-Remedies Act cases many decisions turned on this issue, and the legislative history of the Act suggests it may be a critical factor in Remedies Act cases as well.¹¹⁵

In the pre-Remedies Act cases, courts asked whether a defendant's violation of the law was "isolated" or "recurrent."¹¹⁶ Believing that a person who violates the law repeatedly is likely to continue to do so,¹¹⁷ courts used evidence of repeat offenses to justify the entry of enforcement injunctions.¹¹⁸ Thus, in cases in which there was no evidence of similar misconduct either before or after the violation, courts often found injunctive relief inappropriate.¹¹⁹ When, on the other hand, misconduct had occurred repeatedly over a several-year period, courts were more inclined to enter enforcement injunctions.¹²⁰ The consensus in these cases seemed to be that when a defendant's violations of the securities laws were "part of a chronic pattern of violations,"¹²¹ an injunction might be the only appropriate noncriminal response. These same guidelines should apply in cases in which a Remedies Act order is under consideration,

upward adjustment because of the "extent and magnitude of the harm" he caused, especially to his elderly and disabled clients). See generally C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1085-88 (noting disparate judicial treatment of defendants in civil cases involving sophisticated investors compared to cases involving unsophisticated investors).

114. U.S. SENTENCING COMM'N, *supra* note 111, § 3E1.1(a) (permitting downward adjustment when defendant "clearly demonstrates a recognition and affirmative acceptance of personal responsibility for his criminal conduct").

115. See S. REP. NO. 337, 101st Cong., 1st Sess. 21 (1990) ("A permanent bar might be appropriate if the violation were particularly egregious or the violator was a recidivist.").

116. SEC v. Universal Major Indus., 546 F.2d 1044, 1048 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977).

117. See *infra* text accompanying note 151.

118. Traditionally, recidivism "weigh[ed] heavily in favor of [an] injunction." SEC v. Bonastia, 614 F.2d 908, 913 (3d Cir. 1980).

119. E.g., SEC v. Monarch Fund, 608 F.2d 938, 943 (2d Cir. 1979).

120. See *Bonastia*, 614 F.2d at 913.

121. SEC v. Falstaff Brewing Corp., 629 F.2d 62, 79 (D.C. Cir.) (quoting SEC v. Falstaff Brewing Corp., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,583, at 94,472 (D.D.C. Oct. 28, 1978)), *cert. denied*, 449 U.S. 1012 (1980).

with the understanding that demonstrated recidivism is merely a threshold question and that the SEC must establish other factors discussed below, to warrant the imposition of a remedy as drastic as an executive suspension or bar.

3. The Role of the Defendant in the Scheme to Defraud

The Remedies Act limits courts' authority to enter an executive suspension or bar order to violations of the antifraud statutes, section 17(a)(1) of the Securities Act or section 10(b) of the Exchange Act.¹²² These provisions encompass a wide range of behavior, from insider trading by corporate executives¹²³ to churning by brokers¹²⁴ to aiding and abetting fraud on investors by accountants, lawyers, and others.¹²⁵ Consequently, the first post-threshold question federal courts should consider when presented with a substantial-unfitness inquiry is whether the defendant's unlawful conduct occurred while he was acting as an officer or director of a public company or whether he was acting in some nonexecutive capacity.¹²⁶ The answer to this question should prove significant,

122. 15 U.S.C.S. § 77t(e) (Law. Co-op. 1991); *id.* § 78u(d)(2) (Law. Co-op Supp. 1991).

123. *E.g.*, SEC v. Clark, 915 F.2d 439, 441-42 (9th Cir. 1990) (corporate president secretly bought stock of acquisition target before takeover announcement).

124. *E.g.*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, 906 F.2d 1206, 1210 & n.3 (8th Cir. 1990) (affirming judgment for \$100,000 plus \$2 million in punitive damages against defendant broker who had churned account by making over 100 unauthorized trades); Nesbit v. McNeil, 896 F.2d 380, 381, 387 (9th Cir. 1990) (finding violation by defendant broker who had liquidated some of plaintiff's portfolio and engaged in speculative trading, even though the portfolio increased in value).

125. *E.g.*, Woods v. Barnett Bank, 765 F.2d 1004, 1012 (11th Cir. 1985) (holding liable as aider and abettor a bank that prepared a comfort letter to bond trustee urging disbursement of funds to its client without adequate investigation); Sharp v. Coopers & Lybrand, 649 F.2d 175, 183-84 (3d Cir. 1981) (holding accounting firm liable as aider and abettor under rule 10b-5 because one of its partners wrote a misleading tax opinion letter), *cert. denied*, 455 U.S. 938 (1982); SEC v. Electronics Warehouse, Inc., 689 F. Supp. 53, 65 (D. Conn. 1988) (holding liable as aider and abettor a lawyer who participated in a scheme to extend a public offering beyond its specified deadline and took no steps to amend the prospectus when the company's CEO was indicted for mail fraud), *aff'd sub nom.* SEC v. Calvo, 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 3228 (1990).

126. The legislative history of the Remedies Act confirms the importance of this inquiry:

The Committee believes that the remedy of a bar or suspension from service as a corporate officer or director is especially appropriate in cases in which a defendant has engaged in fraudulent conduct while serving in a corporate or other fiduciary capacity. Although the express authority to grant this relief is not limited to cases involving corporate officers or directors, the legislation would authorize the remedy only when the conduct of the defendant demonstrates the defendant's substantial unfitness to serve as an officer or director.

H.R. REP. NO. 616, 101st Cong., 2d Sess. 27 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379, 1394.

though not dispositive, in determining whether a Remedies Act order is appropriate.

Defendants whose role in the underlying antifraud violation had nothing to do with executive status should benefit from a rebuttable presumption that they are not appropriate subjects for a suspension or bar order; those whose executive status facilitated their misconduct should be burdened by a presumption that they are at least eligible for such an order, assuming other factors, discussed below, are present. Given these presumptions, the psychiatrist caught trading on inside information revealed to him by a patient,¹²⁷ for example, or the chief executive's wife who transmits confidential market information to a relative,¹²⁸ would not be candidates for a Remedies Act order. By contrast, a chief executive who masterminds an elaborate scheme to defraud investors, resulting in millions of dollars in losses;¹²⁹ one who engages in "massive financial fraud" over several years, sells his shares before detection, and then flees the country;¹³⁰ or one with a criminal record for fraud who then participates in misappropriating the proceeds of a public offering¹³¹ would seem to be precisely the sort of person for whom the harshest provisions of the Remedies Act were intended.

It is, of course, possible that the SEC could overcome a defendant's presumption of ineligibility—in other words, that nonexecutive behavior could form the basis for a Remedies Act order. For example, a lawyer serving as outside counsel who is repeatedly implicated in fraudulent securities schemes involving his corporate clients,¹³² an investment banker who masterminds a particularly rapacious insider-trading scheme,¹³³ or an auditor who knowingly and deliberately misrepresents corporate

127. See *Insider Trading Psychiatrist Pleads Guilty to Securities Fraud*, 22 Sec. Reg. & L. Rep. (BNA) 996, 996 (July 6, 1990).

128. See *Genentech's President's Wife Settles SEC Charges She Tipped Brother*, 22 Sec. Reg. & L. Rep. (BNA) 1624, 1624-25 (Nov. 23, 1990).

129. See, e.g., DANIEL AKST, WONDER BOY: BARRY MINKOW—THE KID WHO SWINDLED WALL STREET 4-6 (1990) (investors, banks, and creditors lost at least \$100 million where company's alleged service business was virtually nonexistent).

130. See, e.g., Eddie Antar, Litig. Release No. 12,548, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,341, at 96,655, 96,655-56 (July 18, 1990) (judgment entered in absentia against CEO for \$73.5 million).

131. See *SEC v. Scott*, 565 F. Supp. 1513, 1527 (S.D.N.Y. 1983), *aff'd sub nom.* *SEC v. Cayman Islands Reins. Corp.*, 734 F.2d 118 (2d Cir. 1984).

132. E.g., *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 65 (D. Conn. 1988) (lawyer-defendant performed several unlawful acts in connection with client's public offering), *aff'd sub nom.* *SEC v. Calvo*, 891 F.2d 457 (1989), *cert. denied*, 110 S. Ct. 3228 (1990).

133. See DOUGLAS FRANTZ, LEVINE & CO.: WALL STREET'S INSIDER TRADING SCANDAL 11 (1987) (investment banker made \$11.6 million in net profits by trading on information secured from his own clients, as well as information purchased from his friends); LEVINE, *supra* note 110, at 17 (Levine contending his net profits were \$10.6 million).

value in order to facilitate a significant fraud on investors¹³⁴ might quite reasonably be subject to disqualification from serving as an officer or director of a public company as well as to other civil and criminal sanctions. It generally will be more appropriate, however, for professional misconduct to be addressed through a carefully drawn injunction and the professional disciplinary process than through entry of a Remedies Act order.¹³⁵ Defendants who have never served as public company officers or directors, or whose misconduct is wholly unrelated to their executive status, should only rarely be candidates for an executive suspension or bar.

4. The Defendant's Degree of Scienter

In deciding whether to enter an injunction in pre-Remedies Act cases, courts routinely looked to the defendant's "degree of scienter,"¹³⁶ both in connection with the immediate violation and in connection with extrinsic misconduct.¹³⁷ Not surprisingly, in these cases courts were more likely to enjoin defendants if their violations of the securities laws were intentional than if their conduct was merely reckless or grossly negligent.¹³⁸ Similarly, in criminal cases courts have cited the presence of premeditation and the defendant's leadership role in the crime—both of which are indicators of scienter—as appropriate elements in determining punishment.¹³⁹

Under the Remedies Act, a court cannot enter a suspension or bar order absent a finding of scienter.¹⁴⁰ To warrant this finding, a defendant's conduct may be intentional but, at a minimum, it must be

134. See, e.g., *\$80 Million Settlement by E.S.M. Auditor Seen*, N.Y. TIMES, Sept. 26, 1987, § 1, at 37 (reporting that audit partner accepted bribes to certify false financial statements of E.S.M. Government Securities, Inc. in a scheme that cost investors \$320 million; he was later sentenced to 12 years in prison).

135. Professionals who also serve as corporate officers or directors may be subject to sanctions in both capacities. See, e.g., *Saul Bluestone*, Litig. Release No. 12,589, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,423, at 97,138, 97,139 (Aug. 22, 1990) (SEC alleging that lawyer traded on inside information acquired while serving on a corporate board); *In re Reich*, 128 A.D.2d 329, 331, 515 N.Y.S.2d 775, 777 (1987) (striking lawyer from the roll of attorneys after being convicted of insider trading).

136. *SEC v. Universal Major Indus.*, 546 F.2d 1044, 1048 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977).

137. See, e.g., *Aaron v. SEC*, 446 U.S. 680, 701 (1980) ("An important factor in [the decision to enjoin future conduct] is the degree of intentional wrongdoing evident in a defendant's past conduct.").

138. See, e.g., *SEC v. Bonastia*, 614 F.2d 908, 913 (3d Cir. 1980).

139. See *supra* notes 111-12 and accompanying text.

140. Scienter is a necessary element of claims under § 10(b) of the Exchange Act, see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976), and of claims under § 17(a)(1) of the Securities Act, see *Aaron*, 446 U.S. at 697.

"highly unreasonable, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."¹⁴¹

A court considering whether to enter a Remedies Act order may wish to take note whether the defendant's misconduct was clearly intentional—as in the case of the CEO who traded on inside information through accounts created for that purpose in his wife's maiden name,¹⁴² or the broker who defrauded his customers by sending them falsified profit statements while secretly pocketing their money¹⁴³—or merely the consequence of mismanagement.¹⁴⁴ Positioning the defendant somewhere on the scienter continuum helps the court to focus on the fundamental question posed by the substantial-unfitness standard: whether the defendant is likely to continue to engage in fraudulent conduct regardless of where she is employed.¹⁴⁵ Courts in other contexts have frequently cited incidents of blatant, intentional fraud as especially significant predictors of future unlawful behavior.¹⁴⁶

A subissue may arise in the scienter inquiry: whether the defendant deliberately flouted regulatory warnings that his conduct was unlawful.¹⁴⁷ Cases in which the defendant was made expressly aware of the illegality of his actions, but continued them, may present particularly strong arguments for entry of a Remedies Act order. In any event, the

141. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.) (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976)), *cert. denied*, 434 U.S. 875 (1977).

142. *See SEC v. Clark*, 915 F.2d 439, 441-42 (9th Cir. 1990).

143. *See United States v. Benskin*, 926 F.2d 562, 563 (6th Cir. 1991).

144. *See, e.g., FDIC v. First Interstate Bank*, 885 F.2d 423, 432 (8th Cir. 1989) (holding bank liable as an aider and abettor to customer's fraud where bank had ample evidence customer was dealing in stolen property, and many bank employees had urged terminating the customer's accounts but were overruled by bank executives).

145. *See infra* notes 151-60 and accompanying text.

146. *Cf. SEC v. Paro*, 468 F. Supp. 635, 649 (N.D.N.Y. 1979) (stating that "fraudulent conduct in the past will give rise to an inference of continued future violations"); *SEC v. J&B Indus., Inc.*, 388 F. Supp. 1082, 1084 (D. Mass. 1974) (same); *In re Application of K.B.*, 291 Md. 170, 178, 434 A.2d 541, 545 (1981) ("[T]here can be no doubt . . . that thievery of a repetitive nature, as here, is usually indicative of a serious character flaw.") (quoting *In re Application of David H.*, 283 Md. 632, 640-41, 392 A.2d 83, 88 (1978)).

147. *See, e.g., SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 78 (D.C. Cir.) ("Ignoring warnings of possible violations is relevant [to the question] whether to grant an injunction."), *cert. denied*, 449 U.S. 1012 (1980); *SEC v. MacElvain*, 417 F.2d 1134, 1137 (5th Cir. 1969) (upholding injunction when, following notification by the SEC that their unregistered offering was unlawful, defendants proceeded to make an additional, similar offering), *cert. denied*, 397 U.S. 972 (1970).

court should give careful consideration to the question of the defendant's state of mind.

5. The Defendant's Economic Stake in the Violation

The proceeds question—whether the defendant personally profited from her violation of the securities law—is another appropriate consideration in evaluating the propriety of an executive suspension or bar order under the Remedies Act.¹⁴⁸ Some securities-law violators, such as tippers who do not trade,¹⁴⁹ receive no cash benefits from their misconduct while others, such as those who misappropriate the proceeds of a securities offering or loot a corporation's treasury,¹⁵⁰ certainly do. Lack of an economic stake need not insulate defendants from entry of a Remedies Act order, but the presence of an economic stake in a scheme to defraud investors should serve as an aggravating factor tending to favor such an order.

6. The Likelihood That Misconduct Will Recur

At the core of any inquiry into whether a defendant is substantially unfit to serve as a corporate officer or director is the question whether he is likely to continue to engage in fraudulent conduct. Repeated prior misconduct may be one—indeed the best—predictor of later fraudulent behavior.¹⁵¹ The more interesting question arises when the defendant has no track record of abuse of his corporate position but is a first-time, albeit “egregious,” offender. Criminologists who have studied recidivism among white collar offenders have some, though as yet not much, intelligence to offer on this question.

Contrary to widely held assumptions that white collar offenders seldom recidivate, recent studies show that many of them have a history of unlawful conduct. For example, among a sample of defendants convicted of securities fraud, 27.6% had prior criminal convictions,¹⁵² and

148. See, e.g., *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 69 (D. Conn. 1988) (noting in support of an enforcement injunction that the attorney-defendant had received a \$15,000 fee traceable directly to his violation of the securities law), *aff'd sub nom. SEC v. Calvo*, 891 F.2d 457 (1989), *cert. denied*, 111 S. Ct. 3228 (1990).

149. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974) (holding nontrading tippers liable under rule 10b-5).

150. See, e.g., *SEC v. Scott*, 565 F. Supp. 1513, 1527 (S.D.N.Y. 1983) (finding that defendants had, without disclosure, used proceeds of stock offering to finance real estate venture and interest in speculative new issues), *aff'd sub nom. SEC v. Cayman Islands Reins. Corp.*, 734 F.2d 118 (2d Cir. 1984).

151. See *infra* notes 152-55, 159 and accompanying text.

152. Stanton Wheeler et al., *White Collar Crimes and Criminals*, 25 AM. CRIM. L. REV. 331, 345 (1988).

4% had previously been sentenced to jail.¹⁵³ Among the same sample population, 32% had a prior arrest record and 11% had two or more prior arrests.¹⁵⁴

Of course, looking to recidivists' criminal histories and finding patterns of misconduct retrospectively does not permit one to make predictions of future misconduct from current unlawful behavior. We do know, however, that "evidence of criminal careers can be found even within a highly restricted population of elite white-collar offenders."¹⁵⁵ How one identifies the potential for "career" criminality and measures that potential for a given defendant is precisely the problem that the Remedies Act presents.

Some theorists suggest that people who violate the securities laws are little different from street criminals—they are "relatively unable or unwilling to delay gratification; they are relatively indifferent to punishment and to the interests of others."¹⁵⁶ In more concrete terms, "[t]he securities-fraud offender should have been a youthful mugger but missed the boat."¹⁵⁷ Nevertheless, there is a significant distinction between the demographic characteristics and the recidivism rates of securities law violators and those of street-crime offenders.¹⁵⁸ The demographic distinctions may be attributable in part to the fact that a securities law violator by definition requires higher educational attainment and a higher-status employment position to effectuate her crime than a street thug requires to grab a victim's purse. The reason securities law violators have a lower recidivism rate may be that securities law violations typically depend on

153. David Weisburd et al., *White-Collar Crime and Criminal Careers: Some Preliminary Findings*, 36 CRIME & DELINQ. 342, 346 (1990). Other white collar crimes correlated even more closely with prior criminal activity. For example, among tax offenders, 43.2% had a prior criminal record, Wheeler et al., *supra* note 152, at 345, and 14% had done jail time, Weisburd et al., *supra*, at 346.

154. Weisburd et al., *supra* note 153, at 346. In a separate study of individuals whom the SEC investigated for securities law violations, at least half had been investigated on one or more previous occasions by the SEC, FBI, or other law enforcement agencies, usually for securities fraud. SUSAN P. SHAPIRO, WAYWARD CAPITALISTS 39 (1984).

155. Weisburd et al., *supra* note 153, at 347.

156. Travis Hirschi & Michael Gottfredson, *Causes of White Collar Crime*, 25 CRIMINOLOGY 949, 959-60 (1987).

157. DAVID WEISBURD ET AL., CRIMES OF THE MIDDLE CLASSES: WHITE COLLAR OFFENDERS IN THE FEDERAL COURTS 187 (1991).

158. For example, securities law violators are far more likely than street crime offenders to be white, to be employed, and specifically to be employed in a white collar job. The average age of a securities law violator is 44, considerably older than the typical street crime offender. Weisburd et al., *supra* note 153, at 344-45. As for recidivism, securities law violators have a prior arrest rate of 32%, *id.*, while street crime offenders have a far higher prior arrest rate. A sample of New York City felony defendants in 1971 revealed that almost 66% had prior arrest records and 33% had prior felony convictions. *Id.* at 348 & n.6.

the creation or exploitation of an organization, and do not lend themselves to the sort of unaccompanied, impulsive behavior often characteristic of street crimes.

In addition to being easily distinguishable from street criminals, securities law violators may be distinguishable from other white collar offenders in ways important for the application of the Remedies Act. Specifically, securities law violators may be more prone to repeat their abuses than are other white collar offenders. David Weisburd, a criminologist at Rutgers University, has been following the careers of several hundred white collar offenders *following* their convictions for white collar crimes. His preliminary findings indicate that the securities law violators in his sample have a higher rate of post-conviction "failures" than the total sample.¹⁵⁹ These failures, however, may often represent conduct quite different from that involved in the original conviction. That is, those white collar offenders who recidivate often diversify into new territories of wrongdoing, and their post-conviction conduct may include offenses unrelated to their earlier crime(s).¹⁶⁰

In short, little is yet known about the likelihood of recidivism among first-time white collar offenders generally, or securities law violators specifically.¹⁶¹ Experts do concede that white collar misconduct, like street crime, declines with age.¹⁶² Many also agree that a stigma of the sort that the Remedies Act imposes, like that resulting from incarceration, may well encourage future unlawful behavior rather than, as intended, discourage it.¹⁶³

159. Telephone Interview with David Weisburd, Criminologist, Rutgers University (Sept. 26, 1991).

160. The criminal histories of convicted white collar offenders tend to disprove the notion that offenders "specialize" in a particular type of crime. In fact, "[o]nly one in five white-collar offenders with prior records have previously been convicted of a white-collar crime" of any sort. WEISBURD et al., *supra* note 157, at 66; see also MICHAEL R. GOTTFREDSON & TRAVIS HIRSCHI, A GENERAL THEORY OF CRIME 189 (1990) ("[T]here is little reason to think that the idea of specialization in white collar offenses will bear fruit."). But see Weisburd et al., *supra* note 153, at 349, 352 (suggesting that securities law violators, more than other white collar criminals, may engage in a relatively high degree of specialization).

161. Telephone Interview with David Weisburd, *supra* note 159 ("very little is known about the recidivism of white-collar offenders"); Telephone Interview with Michael Benson, Criminologist, University of Tennessee (Sept. 27, 1991) ("there isn't much [scholarship] that is predictive or useful"); see also Terrill R. Holland et al., *Comparison and Combination of Clinical and Statistical Predictions of Recidivism Among Adult Offenders*, 68 J. APPLIED PSYCH. 203, 203 (1983) ("[R]ecidivism has been resistant to highly accurate prediction, despite numerous and elaborate efforts to accomplish this purpose.").

162. GOTTFREDSON & HIRSCHI, *supra* note 160, at 193 (comparing age distributions for murder with those for fraud and embezzlement). This does not necessarily mean, however, that a single career offender slackens off as he grows older.

163. See JOHN BRAITHWAITE, CRIME, SHAME AND REINTEGRATION 128, 135 (1989) (arguing that stigmatization may result in defendants' developing a desire to get back at the

What this means is that federal district courts confronted with an SEC request for a Remedies Act order will have to do what courts have always done in similar circumstances: trust their instincts.¹⁶⁴ When there is no prior record to review, courts will have to "view [the defendant's] whole life history and his place in society."¹⁶⁵ They will have to assess not only the defendant's fraudulent conduct, but also his motives in getting caught up in the fraud, his subsequent cooperation with the government, and the stability of his family support system.¹⁶⁶ The process is necessarily inexact, but not one foreign to experienced trial judges.

The problem with this process, in addition to its being subject to individual judicial prejudices, is that it inherently tilts in favor of over-sanctioning. In his book *Occupational Crime*, Gary S. Green argues that selective incapacitation schemes, such as that presented by the Remedies Act, inevitably result in courts sanctioning defendants for whom incapacitation is unnecessary ("false positives") far more often than they fail to sanction defendants for whom incapacitation is appropriate ("false negatives").¹⁶⁷ This simply means that judges must exercise self-restraint in

system or joining, with other outcasts, a subculture of resistance and illegality); see also Toni M. Massaro, *Shame, Culture and American Criminal Law*, 89 MICH. L. REV. 1880, 1934-35 (1991) (arguing that, because of their residential and occupational mobility, middle class defendants often find "shaming" punishments ineffective).

164. See STANTON WHEELER ET AL., SITTING IN JUDGMENT: THE SENTENCING OF WHITE-COLLAR CRIMINALS 10 (1988) (describing the sentencing process as one permeated with the personal values and sentiments of the sentencing judge).

165. *Id.* at 102 (quoting federal judge on how he determines sentence for a white-collar offender).

166. *Id.* at 102-20 (discussing these criteria as employed by judges in determining sentences and quoting various judges with regard to same).

167. Green states:

Selective occupational disqualification [bars] individuals from certain future occupational activities on a case-by-case basis. However, selective incapacitation is predicated upon the idea that one can accurately predict which persons need to be incapacitated. This assumption is often incorrect, and the ramifications of an incorrect prediction are substantial. First, there is the person who is predicted to be a nonrecidivist and is allowed to continue in the same occupational role, who then commits another occupational crime. This person is known as a "false negative" (the offender was predicted to be negative on the future criminality trait, but that prediction was false). An error on the other side would involve the person who is predicted to be an occupational recidivist and is disqualified on that basis, but, had that person not been disqualified by being allowed to continue in occupation, no new crimes would have been committed. This situation represents a "false positive" (the person was predicted to be positive on the future criminality trait, but that prediction was false). The result of the false negative is an additional offense (or several of them). The result of the false positive is the infliction of punishment on persons who need not have received that sanction.

... Because incapacitation is rooted in crime control, there will be a tendency to concentrate on the avoidance of false negatives when predicting individual recidivism. This emphasis naturally increases the number of false positives, because when

identifying defendants whom they find "substantially unfit," lest they oversanction.

7. The Defendant's Appreciation of an Executive's Fiduciary Obligations

Interwoven among all of the foregoing issues is a fundamental—and perhaps unanswerable—question: as a result of her experiences, does the defendant comprehend and has she internalized the necessary notions of fiduciary obligation and the standards of care within which executives must operate? In pre-Remedies Act proceedings, courts often framed this issue as one of contrition.¹⁶⁸ There is more, however, to the appreciation issue than the presence of remorse.¹⁶⁹ Defendants must show, through testimony and practice, that they have affirmatively embraced the special and demanding role of an officer or director of a public company.

I do not suggest that, in this context, courts quiz defendants on the principles of corporate governance or that they send defendants to the securities law equivalent of drunk drivers' school. I do suggest, however, that (1) a court satisfy itself that the defendant is at least as worthy of investor trust and confidence as are corporate executives of other public

the prognosticator is unsure about whether an offender will commit another crime, recidivism is likely to be overpredicted. In other words, when in doubt, believe the worst, because underestimating recidivism inflicts more crime. Thus, with selective occupational disqualification, there will be a natural tendency for false positives to outnumber false negatives. False positives are particularly likely to increase immediately after a false negative is discovered (parole boards are more cautious in granting paroles after one of their releasees has been involved in a serious crime).

GARY S. GREEN, OCCUPATIONAL CRIME 248 (1990).

168. See, e.g., SEC v. Murphy, 626 F.2d 633, 655 (9th Cir. 1980) (noting that defendant "insisted that he had done nothing wrong"); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1101 (2d Cir. 1972) (defendants maintained their conduct was blameless even though the district court had found their violations to be "'willful, blatant, and often completely outrageous'") (quoting SEC v. Manor Nursing Ctrs., Inc., 340 F. Supp. 913, 936 (S.D.N.Y. 1971)); SEC v. MacElvain, 417 F.2d 1134, 1137 (5th Cir. 1969) (defendants insisted throughout the trial that their conduct was lawful and that the offering did not fall within the Act's registration requirements), *cert. denied*, 397 U.S. 972 (1970); SEC v. Electronics Warehouse, Inc., 689 F. Supp. 53, 69 (D. Conn. 1988) (defendant's conduct at trial showed "callous indifference" to his wrongdoing), *aff'd sub nom.* SEC v. Calvo, 891 F.2d 457 (1989), *cert. denied*, 110 S. Ct. 3228 (1990).

169. White collar criminals often fail to express remorse, instead rationalizing their wrongdoing with explanations such as "that's the way business is done," "I didn't mean to steal the money, just to borrow it," or "this wasn't murder, after all." See, e.g., Michael L. Benson, *Denying the Guilty Mind: Accounting for Involvement in a White Collar Crime*, 23 CRIMINOLOGY 583, 589-98 (1985). White collar criminals as a group generally do not have criminal self-images. GREEN, *supra* note 167, at 240; Robert Meier & Gilbert Geis, *The Psychology of the White Collar Offender*, in ON WHITE COLLAR CRIME 85, 96 (Gilbert Geis ed., 1982).

companies, and (2) the defendant bear the burden of persuasion on this ultimate issue.

IV. CONCLUSION

The Remedies Act—as it was intended to be—is a potent new weapon for the SEC. Arguing that a defendant is substantially unfit to serve as an executive in any public company may well assist the Commission in extracting favorable prelitigation settlements. Sometimes, however, this leverage will fail, and the issue of executive unfitness will have to be considered on its merits. The stakes will be high. For many defendants, the imposition of a Remedies Act order may be more burdensome and life-altering than a typical securities violation prison sentence would be.¹⁷⁰

In deciding the substantial-unfitness issue, federal courts will be determining who is a suitable candidate for high corporate office and who is not. One need not agree that the Remedies Act is ill considered to recognize the challenge that federal courts inevitably will face in making that determination. This Article attempts to assist courts in that process, while cautioning that simplistic reference to non-Remedies Act jurisprudence may lead to inappropriate results.

170. For example, the median prison sentence for defendants convicted of securities fraud has been calculated to be 12 months. WEISBURD et al., *supra* note 157, at 131. In contrast, a Remedies Act order can prevent a person from being a corporate officer or director for life. See 15 U.S.C.S. § 77t(e) (Law. Co-op. 1991); *id.* § 78u(d)(2) (Law. Co-op. Supp. 1991).