

Ninth Circuit Defines “Extraordinary” for Sarbanes-Oxley Escrow Provisions

by Michael K. Wolensky*

The Sarbanes-Oxley Act of 2002 has been both praised and cursed for the reforms it promised and for those it has brought about. The statute has led to fundamental changes in the corporate governance practices of public companies and their managers, auditors, and legal advisers. One little-used, but (at the time it was enacted) highly-touted, provision is Section 1103,¹ which was designed, essentially, to temporarily freeze “extraordinary payments” made to specified company officials by public companies faced with an SEC investigation. Although the provision has been in place for almost three years, it has been largely inert—perhaps because its mere existence has had the desired prophylactic effect of inhibiting what could be viewed as “extraordinary payments.”

Section 1103 comes into play only if four things happen:

- There is a lawful investigation by the SEC,
- involving possible violations of federal securities laws,
- committed by an issuer of publicly traded securities or any of the issuers’ officials, agents, or employees,

- and the SEC deems it likely that the issuer will make “extraordinary payments” to any of those persons.

When those circumstances occur, the SEC is authorized to petition the federal courts for an order requiring the issuer to escrow the “extraordinary payments” for 45 days. If, within that period (or during a one-time 45-day extension of the period), the SEC brings an enforcement action against the issuer or the proposed recipient, the escrow continues until all legal proceedings concerning that enforcement action are concluded.

In the recent case of *SEC v. Gemstar-TV Guide International*,² the full Ninth Circuit Court of Appeals addressed a number of constitutional and interpretive questions regarding Section 1103. In a decision by a somewhat divided majority of the court, and in the face of a sharply-worded dissent, the court upheld the statute against constitutional challenges and very broadly construed the term “extraordinary payments” to encompass virtually any payment

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to a corporate official, agent, or employee that was not within the ordinary payment practices of the public company in question.

The court considered the case in what it characterized as “a distinctive statutory context.”³ Specifically, the court looked to the particulars of SEC enforcement actions and the public interest characteristics of such actions,⁴ and concluded that Section 1103 was directed to a narrowly defined, regulated, and targeted area such that Congress’ use of the term “extraordinary” did not have any legal or constitutional infirmities. Thus, the court found that in this context any payment that would not typically be made by a company in its customary course of business would fall within the ambit of Section 1103.

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In light of the court’s restrictive, context-limited interpretation and the differing interpretations provided by both the concurring and dissenting opinions, it would appear that when the SEC relies on Section 1103 in other circuits, the provision likely will be subject to differing interpretations and, ultimately, to Supreme Court review.

The Genesis and Effect of the Statute

Section 1103 provides in relevant part:

When, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents or employees, it shall appear to the Commission that it is likely that the issuer will make *extraordinary payments* (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days. (Emphasis added.)

A number of important statutory terms were not defined by Congress—such as “lawful investigation” and “extraordinary payments”—and the statute provides no legal standard for federal courts to apply in assessing the petition to be filed by the SEC. Thus, it remains unstated whether the SEC’s investigation may be informal, or whether there must be a formal order of investigation, and whether the issuer or potentially affected company official need be informed of the existence of the investigation. The SEC is left with full discretion as to when, if ever, it may file such a petition, and it is unclear what standard must be applied to determine whether the SEC is correct in surmising that it is “likely” an extraordinary payment will be made. It also appears that the statute would not be applicable to situations where the SEC does not find out about payments until after the fact; Section 1103 does not authorize any action against the recipient of an extraordinary payment—only against the issuer.

Section 1103 was not part of the initial proposal for Sarbanes-Oxley, but was added as an amendment by Senator Trent Lott shortly before the statute was finally enacted by Congress.⁵ Senator Lott explained that his proposed amendment was meant to prevent “rewards” being given to corporate executives while an SEC investigation was underway because the investigation might involve misconduct by those same corporate officials.

As the Court of Appeals noted, the amendment was intended to prevent corporate officials from pilfering the assets of the company once the SEC began an investigation of corporate malfeasance. However, it seems clear that the statute would have little, if any, effect in those circumstances where the company determines to make such payments not knowing of an SEC investigation, or completes the payments before the SEC becomes aware of them. Obviously, corporate executives bent on “pilfering” the company’s assets would be able to avoid SEC action under Section 1103 by assuring that no public announcement of atypical payments are made until the payments are completed.

The Quintessential Test Case

The Court of Appeals characterized the facts and circumstances of *Gemstar* as a “textbook example” of the problem.⁶ On April 1, 2002, Gemstar filed its Form 10-K for 2001, reporting that \$107.6 million dollars Gemstar had previously claimed as revenue from a single “non-monetary transaction” had not been properly booked and was not actually realized. The next day, Gemstar’s stock price dropped by 37%. Four months later, on August 14, Gemstar filed a Form 8-K reporting that it intended to restate its 2001 financial results to make a number of corrections, including reversing \$20 million in reported revenue. An exhibit to the Form 8-K was a sworn statement from the Company’s CEO Henry C. Yuen and its CFO Elsie M. Leung, declaring they were unable to certify Gemstar’s financial statements as accurate. One month later, on September 25, Gemstar filed another Form 8-K reporting that it had been notified by NASDAQ that its securities were subject to delisting; that it had an unresolved dispute with its independent auditor, KPMG; and that the resolution of the dispute was “uncertain” and “unpredictable.” As the court noted, “the wheels were falling off this company.”⁷

The SEC Inquiry and the “Restructuring Payments”

The SEC by this time had begun an informal investigation and, on October 15, 2002, SEC lawyers met with Gemstar’s counsel. The SEC had learned that Gemstar was planning to restructure its management and corporate governance and that it would be making “restructuring payments” to CEO Yuen and CFO Leung. The “restructuring payments” resulted from lengthy and high-level negotiations within the company. The payments were negotiated over a five-month period among the Gemstar Board of Directors, a special committee of the Board, and outside consultants. The Board, the special committee, and Yuen and Leung each were represented by separate sets of counsel. At the October 15 meeting, the SEC requested that the restructuring payments be held in escrow by Gemstar. The request was denied.⁸ Two days later, the SEC entered a Formal Order of Investigation with

respect to Gemstar’s revenues and earnings or losses, as set forth in Gemstar’s Forms 10-K and 10-Q from 1999 through 2002.

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Finally, on November 7, 2002, Gemstar filed another Form 8-K reporting that Yuen and Leung had reached an agreement with Gemstar under which they would resign from their respective executive positions and remain employees of the company in return for payments in cash by Gemstar to Yuen of more than \$29 million and to Leung of more than \$8 million, along with substantial blocks of restricted Gemstar shares and options. Only hours before final agreement was reached on these “restructuring payments,” the company acceded to the SEC’s request and agreed to escrow the payments for a period of six months.⁹

After some legal skirmishing between the SEC and Yuen and Leung over the voluntary escrow, and an extensive investigation, the SEC filed its petition under Section 1103 in the district court on May 5, 2003, the day before the voluntary escrow was to expire.

Proceedings on the SEC’s Petition in the District Court

The SEC’s petition was filed against Gemstar and did not name Yuen or Leung as defendants. It sought, pursuant to Section 1103, a temporary order requiring Gemstar to escrow the “restructuring payments.” Because the Court of Appeals recited at length the specifics of the SEC’s filing, its declaration setting forth the facts, and a supplemental memorandum of law filed in support of the SEC’s application, we have the benefit of the details of the SEC’s argument in the district court. As might be expected after such a lengthy investigation, the SEC’s arguments were very fact-specific and focused upon why Gemstar’s planned payments to Yuen and Leung were out of the ordinary. The SEC did not address whether the payments included components ordinarily paid by businesses to executives.

Yuen and Leung intervened in the district court and argued that the payments were not “extraordinary” as the term is used in Section 1103. The intervenors argued that the payments were made up of components that were not unusual in a business setting for executives, including a termination fee and a settlement payment for unpaid salary, bonuses, and unused vacation days.

[T]he SEC broadly argued that any bonus would be a special reward outside the ordinary course of business under the circumstances.

The SEC argued in the district court that the extended negotiation of the payments was a factor indicating that they were not usual and ordinary for Gemstar under the officers’ existing employment agreements. The SEC further argued that the payment of previously unpaid bonuses, based upon financial performance that was subsequently restated (and was the precise subject of the SEC’s investigation), was clearly the type of extraordinary payment encompassed by Section 1103. Indeed, the SEC broadly argued that any bonus would be a special reward outside the ordinary course of business under the circumstances. In a similar vein, the SEC argued that the unpaid salary and reimbursed unused vacation days also were rewards of the type Section 1103 was designed to address.

On May 12, 2003, the district court ordered that the restructuring payments be placed in escrow rather than paid to Yuen and Leung.¹⁰ Gemstar did not contest the case or oppose the district court’s escrow order, but Yuen and Leung appealed to the Ninth Circuit.

On June 19, 2003, the SEC filed a federal court enforcement action against Yuen and Leung for violations of various securities laws, and also sought to have the escrow extended for the duration of the enforcement case. The court granted that extension.

The Court of Appeals Decision

The district court’s escrow order was reviewed initially on interlocutory appeal by a court of appeals panel. The panel, 2-to-1, found that the SEC failed to prove what was “ordinary”

in comparable businesses for restructuring payments and remanded the case to the district court.¹¹ The court granted rehearing *en banc*,¹² vacating the panel opinion.¹³

The issues before the full court of appeals included whether the statute was unconstitutionally vague on its face and as applied, whether the district court erred in its interpretation of the term “extraordinary,” and whether the district court erred in determining that the challenged payments were extraordinary.¹⁴ The majority opinion of the court addressed each of the intervenors’ arguments, sometimes dripping with sarcasm. The court recited at great length the tale of horrors Gemstar faced in correcting and restating its financial reports and noted that, while the company was engaged in the “unraveling of this creative accounting mess,” it was also negotiating with its CEO and CFO their exit packages from corporate management, all in the spotlight of the SEC investigation.

There are a number of somewhat unusual features to the majority opinion. First, it recites almost verbatim the text of the SEC’s formal order. Those familiar with SEC enforcement practices will recognize the format: sweeping generalities regarding the events reported by the Staff to the Commission warranting entry of the formal order, as well as the usual boilerplate. While the statute does not appear to require that the SEC have commenced a “formal” investigation, requiring only “a lawful investigation involving possible violations of the Federal securities laws,” the court appears to put substantial weight on the fact that the formal order had in fact been issued.¹⁵ This aspect is particularly interesting because the court finds it “instructive to understand what must happen in order for the Commission to launch an investigation into suspected violations of the securities laws as a prerequisite to petitioning the court under Section 1103 for a temporary escrow.”¹⁶ The court’s recitation suggests strongly that a formal investigation is required before the SEC can invoke Section 1103, although it does note that the SEC conducts “preliminary investigations.” Again, those familiar with SEC enforcement practice know that the staff frequently conducts informal or preliminary investigations of securities violations, and sometimes never obtains a formal

order of investigation in a matter because it is able to secure all of the information it needs without subpoena power.

Next, the court takes the unusual step of providing a detailed verbatim recitation of the SEC's factual declarations submitted in the district court. While it is unclear why the court deemed it necessary to recount some 20 paragraphs from the declaration, or how much the court relied upon any particular portion of the declaration, it is likely to become a roadmap for the SEC in fashioning supporting documentation for future Section 1103 petitions. It also may become a roadmap for defense attorneys challenging the adequacy of such declarations.

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Finally, the court quotes at great length and with repeated emphasis the supplemental legal memorandum filed by the SEC in the district court. The court concluded that the supplemental memorandum "made a compelling case that the payments at issue were not regular payments in the everyday operation or normal management of Gemstar" and therefore were the types of "extraordinary" payments to which the statute was directed.¹⁷

What is "extraordinary" under Section 1103?

The court explained early in its analysis that the determination of whether a payment is "extraordinary" will be a fact-based and flexible inquiry. It noted that courts should look to context-specific factors such as the circumstances under which the payment is contemplated or made, the purpose of the payment, and the size of the payment. It specifically stated that a payment that would otherwise be unremarkable may be rendered "extraordinary" by unusual circumstances. Although a nexus between the payment and the matters being investigated by the SEC is not required, the court suggested that such a nexus might demonstrate that the payment was extraordinary. Finally, the court noted that a company's deviation from an industry standard or from the practice of similarly-situated busi-

nesses might indicate whether a payment should be characterized as extraordinary. The primary emphasis, however, was a consideration of all of the factors in the situation under scrutiny, avoiding any one "litmus test."

[A] payment that would otherwise be unremarkable may be rendered "extraordinary" by unusual circumstances.

The court adopted as its measure for "extraordinary" any departure from what ordinarily goes on in the process of the issuer's business, and it observed that one would normally not expect benefits like those Gemstar proposed to flow from corporate assets to executives resigning under fire from key management positions. The majority opinion treated dismissively the dissent's suggestion that the measure of "extraordinary" must be determined relative to payments made by similarly situated companies under circumstances that have not resulted in an investigation by the SEC but which were otherwise comparable, finding it "odd" that payments could be shielded from the statutory escrow "simply because an ousted insider at some other corporation has been similarly enriched."¹⁸

The "void for vagueness" argument

Having concluded that Gemstar's planned payments constituted "extraordinary payments" under the statute, the court then turned to the argument that Section 1103 is unconstitutionally vague. The court noted that its analysis must begin with a presumption in favor of constitutionality and, because Section 1103 does not concern First Amendment issues, the vagueness challenge must be viewed in light of the facts of the case. On this ground alone, the court rejected the facial challenge to the statute. Concluding that Yuen and Leung could not show that Section 1103 failed to provide people of ordinary intelligence a reasonable opportunity to understand what conduct it prohibits, or that it authorizes or even encourages arbitrary and discriminatory enforcement, the court determined that Section 1103 was not void for vagueness.

The majority concluded by noting that trying to set forth a particular test for all possible situations would not only be next to impossible

but also would serve only to guide “corporate scoundrels searching for ways to circumvent this salutary law.”¹⁹

The Concurring and Dissenting Opinions

Circuit Judges Reinhardt and Graber, while concurring in the result, did not agree that Congress intended courts to consider the range of factors adopted by the majority. Characterizing the majority’s test as “vague and multi-faceted,” the concurring judges noted that they would hold *all* severance packages for corporate officials, and any other substantial, non-routine payments, to be “extraordinary payments” that the district court could properly place in escrow.²⁰ Such a “bright line rule” was said to comport with the purpose of Sarbanes-Oxley, particularly since the SEC ordinarily would need to invoke Section 1103 at the early stage of the investigation when the agency had yet to develop much of the relevant information.²¹

In his dissent, Circuit Judge Bea argued that the majority had erred in two respects. First, the court erred by interpreting “extraordinary payments” to mean “payments under extraordinary circumstances” which, as the majority had noted, would even capture unremarkable payments and could be argued to include any payment made in the midst of circumstances likely to lead to an SEC investigation. Second, he urged that it was error to establish, as the principally relevant standard, whether the circumstances surrounding the payment were extraordinary merely for the company making the payments. Rather, in his view, the SEC must present evidence that a payment was extraordinary relative to payments made by similarly-situated companies, under circumstances that had not resulted in an investigation by securities agencies, but which were otherwise comparable, before the payments would be subject to escrow.²²

What’s in Store for Future SEC Use of Section 1103?

All cases in this area will not provide “text-book examples.” Too often, the SEC tends to push the envelope on enforcement remedies. While a strong majority of the Ninth Circuit judges supported the notion that the circumstances of the payments in light of the issuer’s

experience was the test to be applied, the disputed interpretation of what Congress meant by “extraordinary payments,” as reflected in the concurring and dissenting opinions, suggests that other courts may arrive at different conclusions. In the arena of securities statutes, such a result would, of course, not be uncommon; the circuits have managed to disagree about a number of important provisions of the securities laws over the years.

[T]he Ninth Circuit’s broad interpretation of the statute could serve to substitute the judgment of the [SEC] staff for that of a company’s board as to whether [a payment] is in the best interests of the company.

It also is interesting that Section 1103 was codified as part of Section 21C of the Securities Exchange Act of 1934, which established the SEC’s cease and desist authority. Congress apparently contemplated that an escrow, once temporarily established, could be continued indefinitely by the SEC’s mere entry of an order initiating a cease and desist proceeding. That prospect is somewhat ominous for, as securities practitioners know, such proceedings can extend for many years. The statute could have unintended consequences based upon the breadth of the statutory language and how a combination of SEC Commissioners and a district judge might view some particular payment to a corporate executive. Escrows could be used to tie up legitimate payments for many years without any ruling that a violation occurred.


For example, while the statute is not limited to termination payments paid to executives, a number of extravagant termination payments at “household name” public companies have been reported in the press recently. Dissenting Judge Bea took note of some of these in his opinion.²³ If these payments had been announced in advance at a time when an SEC investigator had opened an informal or preliminary inquiry into some matter relating to the company, they arguably would be subject to Section 1103 proceedings. It is not hard to imagine that a majority of the Commissioners could view such payments as detrimental to a company’s share-

holders or to public investors at large and could determine to seek a temporary escrow while investigating the circumstances, followed by a cease and desist proceeding.

Similarly, because the SEC acts on staff recommendations, the Ninth Circuit's broad interpretation of the statute could serve to substitute the judgment of the staff for that of a company's board as to whether it is in the best interests of the company and its shareholders that payments be made to executives because of what the board viewed as a binding contract provision, or to avoid litigation, or to follow the recommendation made by the company's compensation committee, at a time when the SEC was investigating some aspect of the company's adherence to the federal securities laws.

There also have been situations recently where substantial and unusual payments, beyond those described in extant employment agreements, have been made to company officials as an incentive to "stay on" and continue to lead the company during a period of financial difficulty or government scrutiny. Such a payment, determined by the board to be prudent and advisable, could be subject to escrow under Section 1103, and would likely cause the official to leave the company at a time when the board considered it in the best interests of the company for that executive to remain.

Conclusion

Once the issue is framed, it is not hard to see how many situations, undreamt of by Congress in its zeal to protect public investors when it enacted Sarbanes-Oxley, could come under scrutiny as a result of Section 1103. If, as suggested above, by its mere existence the provision serves to avoid the types of payments almost all could agree are extraordinary, and if the SEC exercises a sound discretion in only seeking to escrow those payments that most would agree are extraordinary (such as the ones in *Gemstar*), there will be little further noteworthy litigation in this area. 

- 1 Section 21C(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-3(c)(3).
- 2 401 F.3d 1031 (9th Cir. 2005) (*en banc*).
- 3 *Id.* at 1044.
- 4 *Cf.* SEC v. Rind, 991 F.2d 1486, 1491 (9th Cir. 1993).
- 5 *See* 401 F.3d at 1036.
- 6 *Id.*
- 7 *Id.* at 1037.
- 8 While not relevant to the issue before it, the court noted that only four days before the filing of the April Form 10-K, CEO Yuen had disposed of seven million Gemstar shares, receiving an initial payment of \$59 million. It also found "telling" that, when questioned by the SEC, CEO Yuen asserted his Fifth Amendment privilege.
- 9 SEC v. Gemstar-TV Guide Int'l, Inc., 367 F.3d 1087, 1089 (9th Cir. 2004) (*vacated*).
- 10 *Id.* at 1090.
- 11 *Id.* at 1087.
- 12 384 F.3d 1090 (9th Cir. 2004).
- 13 401 F.3d 1031. In the vacated opinion, Judge Bea wrote for the panel majority and Judge Trott dissented. The *en banc* decision had their roles reversed.
- 14 Yuen and Leung also claimed that the statute violated the Fourth Amendment's prohibition against unreasonable searches and seizures as the escrow order amounted to a seizure without benefit of a warrant. The Court of Appeals found that this argument had "no merit." The court applied the Supreme Court's three-part test articulated in *New York v. Burger*, 482 U.S. 691 (1987), which established an exception to the warrant requirement, and found the test had been met because there was substantial public interest, the temporary "seizure" was patently necessary to further the regulatory scheme, and the district court was a constitutionally adequate substitute for a warrant. 401 F.3d at 1034 n.1.
- 15 Similarly, while the statute does not require that the company be aware of an extant SEC investigation, the court is silent on this issue. The company's knowledge of the formal investigation at the time the payments were agreed to is recited in the vacated panel opinion. *See* 367 F.3d at 1089.
- 16 401 F.3d at 1037.
- 17 *Id.* at 1041.
- 18 *Id.* at 1047.
- 19 *Id.* at 1048.
- 20 *Id.* Somewhat mockingly, the concurring opinion notes "although the government tends, unabashedly, to give medals to high ranking officials whose missions have ended in disaster, corporations are more likely to give extravagant bonuses to such individuals, while inviting them to leave so as to avoid further public embarrassment." *Id.* at 1049 n.1.
- 21 The opinion tempered its view that all severance payments, even those fully complying with the terms and amounts established entirely and unambiguously by pre-negotiated provisions incorporated in an employment contract long before the investigation commenced, were extraordinary and subject to escrow by noting that just because all severance payments were extraordinary did not mean that all such payments would be automatically frozen when an investigation started since the SEC had discretion to decide whether to request an escrow order.
- 22 401 F.3d at 1051.
- 23 *Id.* at 1057 n.9.