

DIRECTORS' AND OFFICERS' LIABILITY

THE SEC'S TEMPORARY ESCROW AUTHORITY

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On March 22, the Ninth Circuit sitting in banc issued a decision in the closely-watched *SEC v. Gemstar-TV Guide Intern., Inc.*,¹ endorsing the Securities and Exchange Commission's ("SEC") first exercise of its authority under Section 1103 of the Sarbanes-Oxley Act ("SOX"). That provision authorizes the SEC to obtain an escrow order freezing assets when it establishes in a federal district court that a public company is likely to make an extraordinary payment to an officer, director or agent while the Commission is investigating whether the company or that person has violated the securities laws. As in the case's prior appellate proceedings, a high stakes semantic dispute about the proper interpretation of the statutory term "extraordinary payments" divided the court. The majority in large part adopted the SEC's broad and flexible interpretation, creating an important precedent for future efforts by the SEC during the course of an investigation to freeze contemplated payments by public companies. A forceful dissent by Judge Carlos Bea expresses many of the concerns that an expansive interpretation of "extraordinary payments" creates for directors, officers and agents of public companies that may come under SEC investigation. The decision is important reading for advisers to boards of companies under investigation considering making bonus, severance or indemnification payments.

SOX Section 1103

Section 1103 embodies a significant expansion of the SEC's pre-SOX authority to obtain a judicial freeze of assets in order to avoid dissipation. Pre-SOX, the SEC needed to petition a district court to exercise its equitable power after an enforcement action was commenced to preserve assets under Sections 20(b) and 22(a) of the Securities Act of 1933, or Section 21(d) of the Securities Exchange Act, typically first by seeking a TRO, followed by a preliminary injunction to maintain the freeze – both of which required the SEC to demonstrate, *inter alia*, a likelihood of success on the merits of claims against the defendant.

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Section 1103 removes these impediments and eases the SEC's burden in defined circumstances to preserve certain corporate funds so that they remain available, when appropriate, for payment of disgorgement, restitution or civil penalties, or forfeiture by a chief executive officer or chief financial officer under Section 304 of SOX of certain bonuses and securities sale profits in the event of an accounting restatement resulting from misconduct, all of which could ultimately benefit the corporation or its shareholders. Section 1103 provides that 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 appears to the SEC "that the issuer will make extraordinary payments (whether compensation or otherwise)" to any of the foregoing persons, the SEC may seek an order in federal district court placing such payments in an interest bearing escrow account for 45 days.² Section 1103 does not authorize escrow of payments already made.

The initial, pre-complaint escrow cannot exceed 45 days, although the SEC may seek one 45-day extension upon good cause shown. If no enforcement action is brought before the temporary escrow expires, the extraordinary payments "shall be returned to the issuer or other affected person," with accrued interest. Congress did not define "extraordinary payments," and the SEC has not promulgated any regulation doing so. In its Ninth Circuit brief, the SEC advocated a broad and flexible interpretation of the phrase -- "To effect its remedial purpose the phrase 'extraordinary payments' must be broad enough to refer to any payments that, given their size and/or the circumstances under which they are made, are unusual." Section 1103 imposes no penalties.

If the SEC charges the issuer or the person receiving an extraordinary payment with a violation of the federal securities laws before a temporary escrow order expires, "the order shall remain in effect, subject to court approval, until the conclusion of any legal proceedings related thereto, and the affected issuer or other person, shall have the right to petition the court for review of the order."³

Gemstar

Gemstar has three major business sectors, the most profitable of which is its Media and Services Sector, which publishes TV Guide and operates the TV Guide Channel. From 1994 to November 7, 2002, Henry Yuen was Gemstar's CEO and Elsie Leung was its CFO (the "officers"). In 1998, the officers entered into employment agreements with Gemstar which had provisions (i) determining base salary, (ii) calculating annual "merit" and "incentive" bonuses, and (iii) providing rights to vacation pay. The agreement also provided that if Gemstar terminated either without cause, they would receive a lump-sum severance payment in an amount equal to five times the then-current base salary. The officers' entitlement to amounts later calculated under these agreements would be at the center of the SEC's efforts to freeze assets.

April 1, 2002 inaugurated a series of events that led the Ninth Circuit in banc majority to conclude that “the wheels were falling off this company.” Gemstar filed its Form 10-K for 2001, disclosing for the first time that it had reported in public filings, but not actually received, an aggregate of \$107.6 million in revenue based on an expired licensing agreement that was in fact the subject of a federal law suit. Gemstar also disclosed that 20 percent of the 2001 revenues for one of its sectors came from a single “non-monetary transaction,” which Gemstar had valued at \$20 million. These disclosures triggered a 37 percent decline in Gemstar's stock price. A few months later Gemstar announced, *inter alia*, that it would delay its earnings release and filing of its Form 10-Q for the second quarter of 2002, it intended to restate its 2001 financial results and that a restructuring of management was imminent. The Ninth Circuit in banc majority was particularly troubled that amidst the tumult, “all of four days before the revelation to the public about Gemstar's inaccurate revenue claims, Yuen disposed of 7 million Gemstar shares, receiving an initial payment of \$59 million.”

In October 2002 the Commission issued a formal order of private investigation instructing the staff to investigate whether Gemstar and its former and present officers and directors had engaged in securities fraud by making materially false and misleading statements about, among other things, Gemstar's revenues and earnings or losses reported in Gemstar's 1999-2002 annual and quarterly reports.

In November 2002 – simultaneous, as the Ninth Circuit in banc majority noted “with the internal and external unraveling of this creative accounting mess” -- the officers signed extensively negotiated agreements with Gemstar confirming their resignations as CEO and CFO, and providing for Gemstar to pay Yuen \$29.48 million in cash and to pay Leung \$8.16 million in cash. Under their respective agreements, Yuen would also receive approximately five million shares of restricted stock or stock units, and Leung would receive options to purchase more than one million shares of common stock and several hundred shares of restricted stock or stock options. The payments were based on, but lower than, the compensation to which the officers were entitled under their employment agreements upon termination without cause. Gemstar agreed with Yuen and Leung to place the agreed-on payments into segregated, interest-bearing accounts, with title remaining in Gemstar, until May 6, 2003. The parties further agreed that the funds placed into the segregated account would remain Gemstar property until the earlier of (a) the disbursement of the funds in accordance with the terms of an agreement between the SEC and Yuen and (b) the disbursement of any remaining funds to Yuen on May 6, 2003.

On May 5, 2003, the day before Gemstar was scheduled to pay Yuen and Leung \$37 million, the SEC filed an ex parte motion in the Central District of California for a Temporary Escrow Order under Section 1103. Although the application named only Gemstar as the respondent, Yuen and Leung were permitted to intervene. The district court granted the escrow application, concluding that the SEC had satisfied section 1103, including a showing that the payments were “extraordinary.” The SEC then filed a civil complaint against the officers in June 2003, alleging that the officers engaged in a fraudulent scheme to inflate Gemstar's revenues, seeking anti-fraud injunctions, civil money penalties, and disgorgement of alleged ill-gotten

gains, including salaries, bonuses and proceeds from the sale of stock. The commencement of the action automatically extended the escrow order, subject to court approval, until the conclusion of the action. A divided Ninth Circuit panel reversed the temporary escrow order, holding that the SEC had failed to adduce any evidence as to what would be an “ordinary payment under comparable circumstances” involving corporations of similar revenues and worth.⁴

The Ninth Circuit accepted in banc review of the escrow order, and reinstated the district court’s escrow order. The majority rejected with minimal discussion the officers’ constitutional vagueness challenge to Section 1103, noting that economic regulation is subject to a less strict vagueness test than criminal laws. Most of the majority decision, concurring opinion and dissent addressed what may constitute “extraordinary payments” under Section 1103, and whether the disputed Gemstar payments were exempt from an escrow order because they were based on legitimate and longstanding contractual commitments that predated both the passage of Section 1103 and the SEC’s investigation.

Writing for the majority, Judge Stephen Trott commenced by noting the historical backdrop to Section 1103: “One after another, many persons, companies, and pension plans have been left holding an empty bag after corporate insiders committed fraud and other corporate crimes . . . the intent of Congress in enacting this statute was to provide a strong shield for third-party creditors and corporate investors once the SEC begins an investigation of corporate malfeasance.” Turning to the evidence adduced by the SEC to support its escrow order application, Judge Trott quoted the SEC’s moving papers at length to demonstrate the staff’s extensive investigation -- pursuant to the Formal Order of Investigation issued by the Commission -- which was underway when the application was made. The SEC’s submission, which “[i]n many instances, . . . simply pointed out what Yuen and Leung normally would have been entitled to, and then highlighted the differences arising from the Termination Agreements, notable differences that were not usual and not ordinary,” made “a compelling case that the payments at issue were not regular payments in the everyday operation or normal management of Gemstar.” That is, were “extraordinary.”

In what respect? In relation to what? Rejecting any irreducible litmus test, the majority answered these questions by enunciating a fact-based, flexible standard to determine whether a payment “would not typically be made by a company in its customary course of business. The standard of comparison is the company’s common or regular behavior.” The district court may consider “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.” Thus “a payment made by a company that would otherwise be unremarkable may be rendered extraordinary by unusual circumstances.” In addition, the district court may evaluate whether there is any nexus between the alleged wrongdoing and the payment, and may buttress its evaluation by reference to any “‘industry standard’ -- or the practice of similarly situated businesses.”

Applying this flexible test, the majority concluded that the payments under the termination agreements were “‘anything but ordinary.’” As to context, the court reasoned that “‘Gemstar’s execution of its overall business objectives and ordinary management of its business operations did not entail terminating its CEO and CFO in the shadow of misstated revenues, misleading public statements, securities fraud investigations, plunging stock prices, and public relations debacles, not to mention Yuen’s and Leung’s inability to certify Gemstar’s books as accurate.’” As to the amount of payments, the court regarded as extraordinary that funds totaling \$37 million were “‘flowing from corporate assets to executives resigning under fire from key management positions.’”

Judge Stephen Reinhardt wrote a concurring opinion, joined by Judge Graber, agreeing with the result but urging that firm guidance be given to companies that are under investigation by announcing a bright-line rule that “‘all severance packages due top corporate officers and officials, and any other substantial non-routine payments to which they may be entitled, constitute ‘extraordinary payments’ that the district court may order placed in escrow temporarily.’”

A Dissenting View

Judge Bea’s dissent sharply criticized the majority for (i) interpreting ‘extraordinary payments’ to mean ‘payments under extraordinary circumstances,’” and (ii) establishing as the “‘principally relevant standard whether the circumstances surrounding the payments at issue are ‘extraordinary’ not for other companies, but for the company making the payments,” so that now “‘any payment made under any situation novel to that company is now subject to escrow.’” In Judge Bea’s view, “‘the first time a company under SEC investigation gives a departing executive not a golden parachute, but a mere gold watch (or, even, a gold-plated watch), escrow will be available to the SEC.’”

Judge Bea’s dissent underscores the formidable power and discretion a flexible Section 1103 vests with the SEC. First, permitting consideration of the nature, purpose and circumstances of the payments may make “‘any payment following ‘extraordinary circumstances’ ... subject to escrow.’” Section 1103 is not limited to unauthorized payments. Nor does it exempt payments made pursuant to pre-existing contractual obligations, including compensation or perhaps even indemnification agreements. And by relying on many factors “‘certain to be present any time the SEC investigates a company for possible” securities law violations,” it is arguable that “[e]ach payment made in the midst of circumstances likely to lead to an SEC investigation becomes made under ‘extraordinary circumstances,’ therefore an extraordinary payment.” Judge Bea also argued that the majority underestimated what is at stake by emphasizing the short-term duration of the escrow. The 45-day escrow is but the thin end of the wedge, as *Gemstar* demonstrates, in which the spiraling events for the officers resulted in a continuous freeze approaching two years.

¹ 401 F.3d 1031 (9th Cir. 2005) (in banc).

² 15 U.S.C. 78u-3(c)(3)(A)(i).

³ 15 U.S.C. § 78u-3(c)(3)(B)(i).

⁴ 367 F.3d 1087, 1094 (9th Cir. 2004).