Legal Opinion Letter

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FEDERAL COURT RULING WILL IMPACT SEC'S ABILITY TO FREEZE ASSETS UNDER SARBANES-OXLEY ACT

by

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As part of its more aggressive approach to investigating corporate fraud, the Securities and Exchange Commission ("SEC") is relying upon section 1103 of the Sarbanes-Oxley Act to obtain court orders that freeze "extraordinary payments" made by a company to its executives while under investigation. However, in the first appellate decision addressing the application of section 1103, a sharply divided panel of the U.S Court of Appeals for the Ninth Circuit held that the SEC could not block severance payments without providing the district court with evidence that the payments were out of the ordinary. On September 27, 2004, the Ninth Circuit agreed to an *en banc* rehearing of an appeal in *SEC v. Gemstar-TV Guide International, Inc*., most likely for the purpose of defining the term "extraordinary payments." The Ninth Circuit's ruling on that issue will define how far the SEC can go in voiding or modifying executive severance agreements, and barring companies from indemnifying their officers and directors for the cost of defending criminal and civil investigations and proceedings.

The *Gemstar* appeal arose from the SEC's investigation of financial reporting fraud at Gemstar. In late 2002, several months after an internal audit revealed overstated revenues, the company announced restructuring plans and negotiated termination agreements with two top executives, Chief Executive Officer Henry Yeun and Chief Financial Officer Elsie Ma Leung. The agreements provided that Yeun and Leung would receive in excess of $37 million in severance payments.

In October 2002, the SEC commenced a formal investigation into Gemstar's overvaluation, and requested that the severance payments be placed in escrow. While Yeun and Leung would not agree to the escrow request, Gemstar placed the money in escrow, and in May 2003, pursuant to section 1103, the SEC obtained a district court order to escrow the funds for an initial period of 45 days, the length of time prescribed by section 1103.

On June 19, 2003, the SEC sued Yeun and Leung for fraudulently inflating Gemstar's revenue reports and sought to extend the escrow of their termination payments. The district court granted the SEC's request to extend the escrow for an additional 45 days on the ground that the payments made to Yeun and Leung were in fact "extraordinary payments" within the meaning of section 1103. On July 2, 2003, Yeun and Leung appealed that ruling, arguing that section 1103 was void, and that their termination payments were not included in the definition of "extraordinary payments." On May 12, 2004, the Ninth Circuit panel, in a two-to-one ruling, vacated the district court decision and held since neither Congress nor the SEC had

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defined the term "extraordinary payments," the SEC could not prevent Yeun and Leung from collecting their severance packages absent objective evidence as to how the payments are "extraordinary." *SEC v. Gemstar-TV Guide, Int'l, Inc.*, 367 F.3d 1087 (9th Cir. 2004). The Ninth Circuit ruled that section 1103 requires that the payments be out of the ordinary" and stated that "there is no evidence in the record of what similarly placed officers and board members of corporations of similar revenues and worth are paid upon termination. Such payments may be called 'golden parachutes' or 'golden handshakes' in the press, but such purple prose is not enough to prove a statutory requirement in court."

Circuit Judge Stephen Trott dissented, arguing that there was sufficient evidence that the payments to Yeun and Leung were extraordinary and "appear[ed] to be looting." "The Termination Agreement payments here are five or six times greater than Yeun's and Leung's base salary… [and] the bonuses are fruit of the alleged fraudulent financial results. One would not expect benefits like this to be flowing from corporate assets to executives resigning under fire. This scenario is not business as usual." Trott continued: "If these mega-suspicious payments were not 'extraordinary,' the word needs to be either redefined or taken out of the dictionary."

As Judge Trott noted, the Ninth Circuit's current reasoning, if upheld *en banc*, would significantly impact the SEC's efforts to halt severance payments. If all top-tier executives of major corporations have golden parachute agreements, all similar agreements never could be found to be "extraordinary." Indeed, the SEC would be hard-pressed to distinguish one such agreement from another unless the payments were truly a departure from the large payments that are common to the corporate world.

Under this rationale, if the SEC elected to prove that a severance agreement was "extraordinary," the district court would be required to conduct a full-blown evidentiary hearing — a mini-trial — that would explore the origins of the agreement in question to determine whether the company intended to vest the executive with some extraordinary benefit. In addition, a battle of experts would ensue, complete with surveys across the nation with each side using other severance agreements as "objective" evidence to prove their side. The question remains whether the SEC would choose to derail its investigation of corporate fraud to devote the resources necessary to prevail in a section 1103 proceeding.

The Ninth Circuit's ruling will also affect the SEC's ability to freeze advance indemnification payments to officers and directors as "extraordinary payments," as the SEC attempted to do in its complaint against WorldCom. Indemnification payments, which provide resources to officers and directors to defend criminal and civil investigations and class action lawsuits, are undeniably "ordinary" in the corporate world and the SEC would be hard-pressed to prove otherwise. Unless the Ninth Circuit redefines how courts should view "extraordinary payments," such indemnification payments likely will continue, regardless of amount, provided the litigation expenses to be indemnified are reasonable.

By granting *en banc* review, the Ninth Circuit has temporarily prevented section 1103 from being rendered a virtual nullity. The court likely recognized that the SEC would be denied a significant weapon in protecting the investing public. Indeed, with section 1103, the SEC could escrow severance payments for later use as a pool of funds from which a financial settlement could be extracted from executives under fire.

Regardless of the Ninth Circuit's decision, the *Gemstar* case sends a clear message to corporate officers and board members who approve severance and indemnification agreements. Such agreements should be drafted with section 1103 and the inevitable after-the-fact scrutiny in mind. Indeed, even the officers and directors who are not the recipients of the so-called extraordinary payments but approve them should proceed cautiously. A district court finding that payments are "extraordinary" is an invitation for breach of fiduciary duty claims to be leveled against officers and directors who fail to ensure that such payments are acknowledged, commonly utilized, and anything but extraordinary under the circumstances.

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