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# SECTION 1103 OF THE SARBANES-OXLEY ACT: SECURITIES AND EXCHANGE COMMISSION v. GEMSTAR-TV GUIDE INTERNATIONAL, INC., AND THE NINTH CIRCUIT'S INTERPRETATION OF "EXTRAORDINARY PAYMENTS"

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SECTION 1103 OF THE SARBANES-OXLEY ACT: *SECURITIES AND EXCHANGE COMMISSION v. GEMSTAR-TV GUIDE INTERNATIONAL, INC.*, AND THE NINTH CIRCUIT'S INTERPRETATION OF "EXTRAORDINARY PAYMENTS"

INTRODUCTION

The twentieth century ended with a thriving economy,<sup>1</sup> and for the first time in United States history, average citizens were investing in the stock market.<sup>2</sup> Instead of putting money into savings accounts, many were investing their money; they were saving for homes, their children's college education, or their own retirement.<sup>3</sup> Then the corporate scandals hit, one after another—Enron, WorldCom, Adelphia, and Tyco—and many in this new class of investors lost their savings.<sup>4</sup>

The scandals started in 2001, with Enron<sup>5</sup> hiding its losses and deceiving investors.<sup>6</sup> In 2001, Enron "had a \$618 million net loss for the third quarter and would reduce shareholder equity by \$1.2 billion."<sup>7</sup> This had the greatest effect on investors, particularly Enron employees, who had invested their savings in the company.<sup>8</sup> Disturbingly, the corporate executives did not suffer nearly as much from the stock's sudden downturn.<sup>9</sup> This was because corporate of-

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1. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Just Might Work)*, 35 CONN. L. REV. 915, 923 (2003).

2. J. Brent Wilkins, Comment, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 339 (2005).

3. See *id.* (stating that the financial markets are now an important part of many Americans' financial planning).

4. *Id.* at 339-40.

5. Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 357 (2003); Peter T. Muchlinski, *Enron and Beyond: Multinational Corporate Groups and the Internationalization of Governance and Disclosure Regimes*, 37 CONN. L. REV. 725, 727 (2005).

6. Jennifer S. Recine, Note, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1538 (2002).

7. Brickey, *supra* note 5, at 357; Muchlinski, *supra* note 5, at 726; David S. Ruder et al., *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1105 (2005).

8. Recine, *supra* note 6, at 1539; see John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 59 (2005) (stating that the investors in Enron had no idea that this collapse was coming).

9. Kroger, *supra* note 8, at 59; Recine, *supra* note 6, at 1539-40.

ficers prohibited regular employees from selling shares after Enron had restated its earnings.<sup>10</sup> Executives, however, were able to sell their own shares during this blackout period.<sup>11</sup> The executives' deception thus caused many honest, hardworking people to lose their investments.<sup>12</sup> The corporate scandals that followed Enron added to the financial losses of many middle-income investors.<sup>13</sup>

These scandals resulted in a media storm, to which the government reacted quickly, passing the Sarbanes-Oxley Act (SOX) in 2002.<sup>14</sup> SOX is the most significant piece of securities legislation since the 1930s<sup>15</sup> and imposes new and stricter regulations on the business community.<sup>16</sup> Many sections of SOX impose greater liabilities on corporate officers.<sup>17</sup> SOX also enables the Securities and Exchange Commission (SEC) to enforce stricter penalties against corporate officers.<sup>18</sup> One of these penalties permits the SEC to temporarily freeze, in escrow, payments made to Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs).<sup>19</sup>

Section 1103 of SOX allows the SEC to obtain a court order to temporarily freeze any "extraordinary payments" to be paid to cor-

10. Recine, *supra* note 6, at 1539.

11. *Id.* at 1539-40.

12. *See id.* at 1539 ("Enron's Chief Executive Officer (CEO) Kenneth Lay encouraged employees to continue investing in Enron even as he was dumping his own shares.").

13. Cunningham, *supra* note 1, at 923-25.

14. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005).

15. Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of 2002*, 56 ADMIN. L. REV. 135, 137 (2004); *see also* President George W. Bush, President's Ten-Point Plan, available at <http://www.whitehouse.gov/infocus/corporateresponsibility/index2.html> (last visited Jan. 2, 2007) ("[T]he Sarbanes-Oxley Act of 2002 [is] the most far-reaching reform of American business practices since the time of Franklin D. Roosevelt.").

16. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.) (creating many different provisions within securities law).

17. *See* Gorman & Stewart, *supra* note 15, at 148 (stating the Act makes executives responsible for protecting the company). Some examples include the obligation to certify financial statements and to assume personal liability for incorrect statements. *Id.* at 152.

18. *See* Joel M. Androphy & Thomas Graham, *2002: A Legal Perspective: Criminal Law: White Collar Crime Update*, 66 TEX. B.J. 66, 66-67 (2003) (listing the different penalties enacted by SOX). One example of this is barring executives from serving on the board of directors. 15 U.S.C. § 78u(d)(2) (Supp. IV 2004); Androphy & Graham, *supra*.

19. 15 U.S.C. § 78u-3(c)(3) (Supp. IV 2004); Androphy & Graham, *supra* note 18, at 67.

porate officers.<sup>20</sup> Since the passage of SOX, the SEC has struggled to define the phrase “extraordinary payments.”<sup>21</sup> Recently, the Ninth Circuit’s decision in *Securities and Exchange Commission v. Gemstar-TV Guide International, Inc.*, interpreted the meaning of “extraordinary payments.”<sup>22</sup> The majority, dissenting, and concurring opinions set out three different tests for interpreting the phrase.<sup>23</sup> This Note agrees with the holding in *Gemstar* but argues that the test that the majority uses in interpreting “extraordinary payments” is not effective. The concurrence’s test is more appropriate because it would better enforce the purposes of SOX, make the provision easy to administer, and help deter violations of securities law.

This Note will analyze the *Gemstar* decision and discuss the tests set out therein. Part I will provide background on SOX, including its passage, its purpose, and a description of section 1103. Part II will discuss the history of the *Gemstar* case and the Ninth Circuit’s decision, as well as other cases interpreting “extraordinary expenses” used in both the majority and dissenting opinions of the *Gemstar* decision. Part III will analyze the three different tests for interpreting “extraordinary payments.” Part III will also argue that providing a bright-line rule to evaluate “extraordinary payments” in the context of severance packages is the best approach.

## I. BACKGROUND

### A. Securities Law Prior to SOX

The major role of the Securities and Exchange Commission (SEC) is to act as an advocate for investors.<sup>24</sup> It is a small federal

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20. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, tit. XI, § 1103, 116 Stat. 745, 807 (2002) (codified at 15 U.S.C. § 78u-3(c)(3)).

21. See Michelle Rice, *Securities Enforcement: The Ninth Circuit Confines the SEC’s Enforcement Powers Under Section 1103 of Sarbanes-Oxley*, INSIGHTS, June 2004, at 2, 4 (stating that the SEC is unclear about what defines an “extraordinary payment”).

22. See generally *SEC v. Gemstar-TV Guide Int’l, Inc.*, 401 F.3d 1031 (9th Cir. 2005), cert. denied, 126 S. Ct. 416 (2005).

23. *Id.*

24. SEC, *The Investor’s Advocate: How the SEC Protects Investors and Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (last visited Jan. 2, 2007) [hereinafter “The Investor’s Advocate”]. The Securities Exchange Act of 1934 created the SEC. 15 U.S.C. § 78d(a) (2000). The SEC includes a five-member commission, four divisions, and eighteen offices. *Id.*; THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.3, at 26-28 (4th ed. 2002) [hereinafter HAZEN 4th ed.]; *The Investor’s Advocate*, *supra*. The five-member commission

agency that oversees all aspects of the securities markets.<sup>25</sup> The SEC gives effect to securities law through the enforcement of several different federal statutes,<sup>26</sup> including the Securities Act of 1933,<sup>27</sup> the Securities Exchange Act of 1934,<sup>28</sup> and the Sarbanes-Oxley Act of 2002.<sup>29</sup>

## B. *Enactment and Purpose of SOX*

### 1. Road to SOX

The thriving economy of the 1990s caused a rise in the stock market and drew in many new investors.<sup>30</sup> Around the turn of the century, however, corporate scandals started to surface, one after

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is appointed by the President. 15 U.S.C. § 78d(a); HAZEN 4th ed., *supra*, at 26-27; The Investor's Advocate, *supra*.

25. HAZEN 4th ed., *supra* note 24, at 22; Harvey L. Pitt, Chairman, SEC, Speech by SEC Chairman: Remarks Before the U.S. Department of Justice Corporate Fraud Conference (Sept. 26, 2002), *available at* <http://www.sec.gov/news/speech/spch585.htm>. While the SEC is a small agency, it serves many important functions. These include: "Protect[ing] Investors," "Maintain[ing] Fair, Honest, and Efficient Markets," "Facilitate[ing] Capital Formation," and "Sustain[ing] and Improv[ing] Organizational Excellence." SEC, GOVERNMENT PERFORMANCE AND RESULTS ACT (GPRA), 2004 ANNUAL PERFORMANCE PLAN AND 2002 ANNUAL PERFORMANCE REPORT 16 (2003), *available at* [http://www.sec.gov/about/gpra2004\\_2002.pdf](http://www.sec.gov/about/gpra2004_2002.pdf) [hereinafter GOVERNMENT PERFORMANCE].

26. GOVERNMENT PERFORMANCE, *supra* note 25, at 9-10; The Investor's Advocate, *supra* note 24.

27. The Securities Act of 1933 requires that companies register their securities with the SEC, and mandates that the information provided during the registration process be accurate. 15 U.S.C. § 77(f) (2000); HAZEN 4th ed., *supra* note 24, at 21.

28. The Securities Exchange Act of 1934 created the SEC and requires corporations to file regular reports. 15 U.S.C. § 78(d) (2000); The Investor's Advocate, *supra* note 24. The Securities Exchange Act of 1934 also prohibits insider trading, and requires "a variety of market participants to register with the commission." SEC, The Laws that Govern the Securities Industry, <http://www.sec.gov/about/laws.shtml> (last visited Jan. 2, 2007); 15 U.S.C. §§ 78o, 78p (2000); *see also* The Investor's Advocate, *supra* note 24.

29. The Investor's Advocate, *supra* note 24; GOVERNMENT PERFORMANCE, *supra* note 25, at 9-10. The SEC also uses the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940 to reach these goals. The Investor's Advocate, *supra* note 24; GOVERNMENT PERFORMANCE, *supra* note 25, at 10.

30. William H. Donaldson, Chairman, SEC, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002 (Sept. 9, 2003), <http://www.sec.gov/news/testimony/090903tswhd.htm> [hereinafter "Testimony Concerning Implementation"]; Wilkins, *supra* note 2, at 339-40 (stating that the 1990s brought a lot of new investors into the stock market). Historically, only the wealthiest people invested in the stock market; however, in the 1990s many "ordinary people" started to use the stock market as a tool to save for retirement, or to grow their savings. *Id.* In the past two decades, the percentage of U.S. households investing in the stock market has grown from 20 to 50 percent. *Id.*; *see also* Neil H. Aronson, *Preventing Future Enrons: Implementing the*

another, and the financial markets began to fall.<sup>31</sup> Between March 2000 and September 2002, the falling stock markets caused an \$8.5 trillion drop in investors' net worth.<sup>32</sup> In response to the failing markets and corporate scandals, Congress passed SOX.<sup>33</sup>

The growing stock market of the 1990s created an environment that pressured companies to meet or exceed their goals every quarter.<sup>34</sup> However, corporations were not the only entities to blame for the environment that contributed to the corporate scandals.<sup>35</sup> Due to insufficient funding, the SEC did not have the financial resources to investigate many of the potential scandals.<sup>36</sup> Therefore, the pressures felt by companies in the 1990s, along with the weakness of the SEC, provided the opportune climate for corporate misbehavior, and the resulting corporate scandals pushed the problems of corporate governance to the forefront.

Between November 2001 and June 2002, Enron, Global Crossing, Adelphia, and WorldCom all filed for bankruptcy.<sup>37</sup> Because the number of stock market investors had grown, these scandals had a significant impact on the voting behavior of many Americans.<sup>38</sup> This led politicians to act quickly.<sup>39</sup> The mid-term elections

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*Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 132 (2002); Cunningham, *supra* note 1, at 923-24.

31. Cunningham, *supra* note 1, at 924-27.

32. Aronson, *supra* note 30, at 127.

33. *Id.* at 128; Cynthia A. Glassman, Comm'r, SEC, SEC Speech: SEC Initiatives Under Sarbanes-Oxley and Gramm-Leach-Bliley (Feb. 26, 2003), available at <http://www.sec.gov/news/speech/spch022603cag.htm>.

34. Testimony Concerning Implementation, *supra* note 30. This compelled executives, auditors, and accountants to "stretch" the numbers. *Id.* A major problem during this period was the dilemma of an investment banking securities analyst. Aronson, *supra* note 30, at 131. Investment banks often won big underwriting contracts by giving good analyst reports. *Id.* Therefore, in order to get big contracts, many analysts never recommended selling securities. *Id.* Also, there are reports that some analysts recommended the stocks of the companies affected by the scandals—even as the companies were falling apart. Glassman, *supra* note 33.

35. Aronson, *supra* note 30, at 131-32. This Note does not mean to suggest that a majority of corporate executives engage in unlawful conduct. Indeed, "the vast majority of American businessmen and women are enterprising, honest and hardworking." *Conference Report on Corporate Responsibility Legislation: Capitol Hill Hearing*, FED. NEWS SERVICE (July 24, 2002), available at LEXIS; GENFED; FEDNEW (statement of Rep. Michael Oxley) [hereinafter *Conference Report on Corporate Responsibility Legislation*]. Moreover, "[n]obody should assume that because there have been a very small number of people who had been irresponsible that this represents the American free enterprise system." *Id.* (statement of Rep. Paul Kanjorski).

36. Aronson, *supra* note 30, at 131-32.

37. Recine, *supra* note 6, at 1537. These were four of the largest bankruptcies in American history. *Id.*

38. Wilkins, *supra* note 2, at 339-40.

of 2002 were around the corner, and the media attention that surrounded the corporate scandals virtually guaranteed the Act's passage.<sup>40</sup> Indeed, SOX was passed with little debate or opposition.<sup>41</sup>

While SOX was passed in haste, and with little debate, it was not the first response to the growing problem of corporate governance. Before SOX, President George W. Bush had proposed what he described as a ten-point plan.<sup>42</sup> The President's ten-point plan was focused on the investor and on correcting corporate governance problems.<sup>43</sup> However, the President's plan received criticism from Republicans and Democrats alike, who claimed that the plan lacked sufficient "teeth" to deter corporate wrongdoers.<sup>44</sup> Congress was looking for a solution that would make corporate officers accountable.<sup>45</sup>

Congress found its solution in SOX. SOX was passed "virtu-

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39. *Id.* at 343.

40. Romano, *supra* note 14, at 1523-24.

41. *Id.* at 1528. In fact, even Republicans in Congress, who tend to lean more toward business freedom, did not oppose the bill. *Id.* They were afraid of what opposition to this Act could do to their careers. *Id.*; *see also* Wilkins, *supra* note 2, at 343 (stating that SOX was passed in haste).

42. Recine, *supra* note 6, at 1545-46; Bush, *supra* note 15.

43. Bush, *supra* note 15. The ten points of the plan were:

- (1) Each investor should have quarterly access to the information needed to judge a firm's financial performance, condition, and risks.
- (2) Each investor should have prompt access to critical information.
- (3) CEOs should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including their financial statements.
- (4) CEOs or other officers should not be allowed to profit from erroneous financial statements.
- (5) CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions.
- (6) Corporate leaders should be required to tell the public promptly whenever they buy or sell company stock for personal gain.
- (7) Investors should have complete confidence in the independence and integrity of companies' auditors.
- (8) An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards.
- (9) The authors of accounting standards must be responsive to the needs of investors.
- (10) Firms' accounting systems should be compared with best practices, not simply against minimum standards.

*Id.*

44. Recine, *supra* note 6, at 1545-46. Part of the problem with the President's plan was the absence of any increased criminal penalties. *Id.* at 1548.

45. *See Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Rep. Michael Oxley) (stating that "corporate executives who break the law and abuse the public trust [must] pay severely").

ally unanimously” by Congress,<sup>46</sup> and has minimal clarifying legislative history.<sup>47</sup> This led to criticism that SOX was not well thought out, and that the lack of debate would lead to problematic legislation.<sup>48</sup> In fact, Republican Senator Phil Gramm, “who reversed his opposition to the bill, acknowledged that given the environment, ‘literally anything could have passed.’”<sup>49</sup> Consequently, due to pressure from the corporate scandals and the surrounding media attention, SOX passed with little opposition.

## 2. Purpose and Goals

### a. *Investor confidence*

After the corporate scandals, there was wide recognition that something had gone wrong in corporate America; as a result, many investors lost confidence in the failing markets.<sup>50</sup> While investors had been able to shrug off the earlier failures of the dot-com companies, it was harder to ignore the failures of larger, more established corporations.<sup>51</sup> Investor confidence had been shaken, and it was clear that in order to return investors to the market, something had to be done to restore their confidence.<sup>52</sup> The main goals of SOX, therefore, were to restore investor confidence and protect investors from future corporate scandals.<sup>53</sup>

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46. Wilkins, *supra* note 2, at 343. The roll call vote in the House of Representatives shows that there were 423 yeas, 3 nays, and 8 not voting. 148 CONG. REC. H5462, M5480 (daily ed. July 25, 2002). The Senate vote on the conference report was 99-0. 148 CONG. REC. S7350 (daily ed. July 25, 2002).

47. Gorman & Stewart, *supra* note 15, at 141-42.

48. Romano, *supra* note 14, at 1528-29. Critics of the Act argue that, due to the Act’s quick passage, a law was created that is disorganized and unnecessary. Michael A. Perino, *Enron’s Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN’S L. REV. 671, 672-74 (2002).

49. Recine, *supra* note 6, at 1548-49 (quoting Marcy Gordon, *Bush Receives Corporate Reform Bill, Congress Gives Measure Easy O.K.*, CHI. TRIB., July 26, 2002, at 11).

50. Testimony Concerning Implementation, *supra* note 30.

51. Aronson, *supra* note 30, at 128.

52. Glassman, *supra* note 33.

53. *Id.* The SEC expects to reach these goals by improving corporate governance through SOX. Aulana Peters, *Goodwin Seminar: Sarbanes-Oxley Act of 2002, Congress’ Response to Corporate Scandals: Will the New Rules Guarantee “Good” Governance and Avoid Future Scandals?*, 28 NOVA L. REV. 283, 284-85 (2004). However, critics of the Act doubt SOX will improve corporate governance, and claim that these new provisions will not change anything. *Id.* In fact, Enron’s corporate governance plan would have satisfied the requirements of SOX. *Id.*



*b. Corporate accountability and deterrence*

SOX regulates many different aspects of corporate law.<sup>54</sup> In many of its provisions, SOX creates disclosure requirements that are new to securities regulation.<sup>55</sup> Some portions of the Act that help to ensure corporate accountability and deterrence are the code of ethics provision,<sup>56</sup> the requirement that executives certify company reports,<sup>57</sup> and the decreased standard for director removal.<sup>58</sup> All of the provisions take positive steps to help deter corporate misbehavior and provide a foundation for the SEC to promote disclosure and to work with corporations to help ensure that investors are protected from wrongdoing.<sup>59</sup>

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54. Robert C. Brighton, Jr., *Sarbanes-Oxley: A Primer for Public Companies, and Their Officers and Directors, and Audit Firms*, 28 NOVA L. REV. 605, 626-29 (2004). SOX regulates, among other things, CEO and CFO certifications, loans to directors and executive officers, whistleblower protection, forfeiture of bonus and share trading profits, audit committees, "Real Time" disclosure, internal controls disclosure, pro forma financial information, extension of statutes of limitations, auditor oversight, and auditor independence and rotation. *Id.*

55. Aronson, *supra* note 30, at 139, 148-50.

56. 15 U.S.C. § 7264 (Supp. IV 2004). Section 406 of SOX provides that the SEC will make rules which require the public to be informed about a company's Code of Ethics. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 9.7(2) (5th ed. 2005) [hereinafter HAZEN 5th ed.]. The purpose of this provision, and the rules adopted by the SEC pursuant to the Act, is to promote "honest and ethical conduct." *Id.*; 15 U.S.C. § 7264(c). As part of "honest and ethical" conduct, a company's code of ethics must include how a company would handle a conflict of interest, and must also encourage full disclosure of the company's SEC filings. *Id.*; HAZEN 5th ed., *supra*, at § 9.7(2).

57. 15 U.S.C. § 7241 (Supp. IV 2004); Testimony Concerning Implementation, *supra* note 30.

58. Androphy & Graham, *supra* note 18, at 67. Previously, the standard required a potential board member be "substantially unfit"; today, the SEC only needs to prove that an individual is "unfit," thus lowering the standard. *Id.*; *see also* 15 U.S.C. §§ 77t(e), 78u(d)(2) (Supp. IV 2004). Previously, the SEC needed a court order to bar an officer; now the SEC is able to bar officers without a court order. Philip F.S. Berg, *Unfit to Serve: Permanently Barring People from Serving as Officers and Directors of Publicly Traded Companies after the Sarbanes-Oxley Act*, 56 VAND. L. REV. 1871, 1887 (2003). This provision has already had an impact on the way the SEC pursues corporate wrongdoers. In 2001, the SEC only sought to bar fifty-one officers from the boardroom; this figure increased to about 300 officers a year by 2004. Stephen M. Cutler, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program*, INSIGHTS, June 2004, at 18, 22. In fact, the SEC pursued a permanent bar of Gemstar's CEO when it filed charges against Gemstar. Press Release, SEC, SEC Sues Former CEO and CFO of Gemstar-TV Guide for Financial Fraud Scheme (June 19, 2003), available at <http://www.sec.gov/news/press/2003-75.htm>. The SEC succeeded in barring Gemstar's CEO from the boardroom. SEC v. Yuen, No. CV-03-4376, 2006 U.S. Dist. LEXIS 34759, at \*8 (C.D. Cal. May 8, 2006).

59. Two other provisions of SOX worth mentioning, because they are examples of an increased duty for executives to disclose, are: the requirement of insider transaction

### C. *Extraordinary Payments: Section 1103*

In order to help enforce the Act and to deter potential violators, SOX also contains provisions that give the SEC tools to punish corporate wrongdoers, and compensate harmed investors.<sup>60</sup> One of these tools is section 1103.<sup>61</sup> The SEC can use section 1103 to put into escrow any “extraordinary payments” made to CEOs and CFOs while the SEC is investigating possible securities violations.<sup>62</sup> If violations of SOX are found, the SEC can use the escrowed money to compensate investors.<sup>63</sup>

#### 1. Section 1103

Section 1103 amends section 21C(c) of the 1934 Securities Exchange Act.<sup>64</sup> Section 1103(a) provides the SEC with the power to issue a temporary escrow order:

Whenever 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 compensatory 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.<sup>65</sup>

The remainder of section 1103 provides that the freeze be-

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disclosures, and the prohibition on insider trading during pension blackouts. 15 U.S.C. §§ 78p, 7244 (Supp. IV 2004); Testimony Concerning Implementation, *supra* note 30. The disclosure of insider transactions provides for earlier public notification of when securities have been traded by insiders. 15 U.S.C. § 78p(2); Testimony Concerning Implementation, *supra* note 30. The prohibition on insider trading during pension blackouts attempts to equalize the playing field among employees and executives in the sale of stock by preventing corporate officers from selling their stock when the corporation has imposed a pension blackout for the rest of the employees in the company. 15 U.S.C. § 7244(1); Testimony Concerning Implementation, *supra* note 30.

60. Testimony Concerning Implementation, *supra* note 30.

61. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, tit. XI, § 1103(a), 116 Stat. 745, 807-08 (2002) (codified at 15 U.S.C. § 78u-3(c)(3) (Supp. IV 2004)); Testimony Concerning Implementation, *supra* note 30.

62. Sarbanes-Oxley Act of 2002 § 1103(a); 15 U.S.C. § 78u-3(c)(3). This provision is not only for “extraordinary payments” paid out to CEOs and CFOs but also payments made to “directors, officers, partners, controlling persons, agents, or employees.” Sarbanes-Oxley Act of 2002 § 1103(a); 15 U.S.C. § 78u-3(c)(3)(A)(i).

63. Testimony Concerning Implementation, *supra* note 30.

64. Sarbanes-Oxley Act of 2002 § 1103.

65. *Id.* § 1103(a) (codified at 15 U.S.C. § 78u-3(c)(3)(A)(i)).

comes effective immediately, and is only effective for 45 days, unless the court grants an extension for another 45 days.<sup>66</sup> There is also an exception: if charges are filed before the end of the period for which payments are frozen, then the freeze will stay in effect until the conclusion of the legal proceedings.<sup>67</sup> If the executive is not charged with a violation of securities law within the freeze period, the money is returned to the executive.<sup>68</sup>

## 2. History and Purpose

According to Representative Jim Sensenbrenner, “top executives will not be allowed to pilfer assets of the company by giving themselves huge bonuses and other extraordinary payments if the company is subject to an SEC investigation.”<sup>69</sup> The legislative history on section 1103 demonstrates that Congress’s intent in passing this section was to prevent executives from benefiting from their own misconduct.<sup>70</sup> As Senator Trent Lott stated, the purpose of this provision was to “ensur[e] that corporate assets are not improperly taken for an executive’s personal benefit.”<sup>71</sup>

Prior to the passage of section 1103, the SEC had been able to freeze payments, but only after it had filed charges for a securities violation.<sup>72</sup> The new provision allows the SEC to get a court order to freeze payments any time after it has commenced an investigation, thereby avoiding the possibility that corporate officers will plunder corporate assets before the SEC has enough evidence to

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66. *Id.* § 1103(a) (codified at 15 U.S.C. § 78u-3(c)(3)(A)(iii) to (iv)).

67. *Id.* § 1103(a) (codified at 15 U.S.C. § 78u-3(c)(3)(B)(i)).

68. *Id.* § 1103(a) (codified at 15 U.S.C. § 78u-3(c)(3)(B)(ii)).

69. 148 CONG. REC. H4683, 4685 (daily ed. July 16, 2002). This coincides with a theme present throughout the Act: to aggressively pursue CEOs and CFOs who have committed wrongdoing. Otis Bilodeau, *SEC to Go After Directors Who Ignore Fraud; Case Against Former Outside Board Member of Firm Will Be Model*, CHI. SUN, Aug. 21, 2004, at 51.

70. 148 CONG. REC. H4683, 4685 (daily ed. July 16, 2002); 148 CONG. REC. S6524, 6545 (daily ed. July 10, 2002) (statement of Sen. Trent Lott).

71. 148 CONG. REC. S6524, 6545 (daily ed. July 10, 2002).

72. Wesley Bowen Gilchrist, *Turning Up the Heat: The SEC's New Temporary Freeze Authority*, 56 ALA. L. REV. 873, 881 (2005). The Securities Exchange Act of 1934 standard for freezing assets was much stricter than the standard under the Sarbanes-Oxley Act. See Rice, *supra* note 21, at 2. Under the 1934 Act, the commission needed to prove that “a legitimate concern exist[ed],” and that if the assets were not frozen, the assets would disappear. *Id.* Also, the court was required to consider several factors, including whether the freeze would interfere with a company’s business, whether the freeze was “narrowly tailored,” the effect on the defendant, and whether the amount was more than the SEC could recover. *Id.* In contrast, the new provision requires only that “it ‘appears to the commission’ that an ‘extraordinary payment’ is likely to be made by an issuer.” *Id.* at 3.

officially file charges.<sup>73</sup>

Interestingly, the temporary freeze authority was initially proposed by President Bush in July of 2002 as part of his corporate-responsibility initiative.<sup>74</sup> However, this freeze authority was not originally part of SOX.<sup>75</sup> Senator Trent Lott introduced the provision as an amendment, which passed unanimously.<sup>76</sup> Its purpose is to use corporate officers' golden parachutes to reimburse investors after the corporate officers have committed corporate wrongdoing.<sup>77</sup>

The new SEC power was designed to increase investor confidence.<sup>78</sup> Congress's purpose was to prevent executives from benefiting from misconduct while investors lose money.<sup>79</sup> While this provision can help the SEC restore investor confidence, there remains the question of what Congress meant by "extraordinary payments" as used in section 1103.<sup>80</sup> Although the SEC has the ability to define this phrase, it has not done so.<sup>81</sup> The courts have been left to interpret what Congress meant by "extraordinary payments," and this is exactly what the Ninth Circuit did in *Gemstar*.<sup>82</sup>

## II. SEC v. GEMSTAR-TV GUIDE INTERNATIONAL, INC.

### A. Procedural History

The *Gemstar* case arose when the SEC placed the termination packages of the CEO and the CFO of Gemstar-T.V. Guide International, Inc. into escrow.<sup>83</sup> The district court granted the SEC's ap-

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73. *Id.*; see also Rice, *supra* note 21, at 2 (stating that the purpose of section 1103 was to stop executives from taking money from their own corporations).

74. Gilchrist, *supra* note 72, at 880; see also Press Release, The White House, A New Ethic of Corporate Responsibility (July 9, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020709.html>.

75. Gilchrist, *supra* note 72, at 881.

76. *Id.*

77. Pitt, *supra* note 25; Testimony Concerning Implementation, *supra* note 30; Gilchrist, *supra* note 72, at 875.

78. "This 'preventive measure' helps to address one of the toughest challenges facing the Commission—finding, recovering, and returning funds to defrauded investors—by securing funds before they are provided to alleged securities-law violators." Testimony Concerning Implementation, *supra* note 30.

79. 148 CONG. REC. H4683, 4685 (daily ed. July 16, 2002).

80. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, tit. XI, § 1103(a), 116 Stat. 745, 807-08 (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(i) (Supp. IV 2004)).

81. SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1052 (9th Cir. 2005).

82. *Id.*

83. SEC v. Gemstar-TV Guide Int'l, Inc., No. CV 03-3124, 2003 U.S. Dist. LEXIS 8707 (C.D. Cal. 2003), *aff'd*, 401 F.3d 1031 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 416 (2005).

plication in accordance with section 1103 of the Sarbanes-Oxley Act.<sup>84</sup> On appeal, the Ninth Circuit vacated the district court's ruling due to a lack of evidence establishing that the payments were "extraordinary."<sup>85</sup> The judgment was subsequently vacated and remanded.<sup>86</sup> Later, the Ninth Circuit ordered the case re-heard en banc.<sup>87</sup> The en banc hearing led to the reversal of the original Ninth Circuit ruling.<sup>88</sup> The court concluded that the payments were "extraordinary payments." The result of the original dissenting opinion became the result of the majority opinion, and the result of the original majority opinion became the result of the dissenting opinion.<sup>89</sup>

## B. *The Gemstar Case*

### 1. The Facts of the Case

In April 2002, Gemstar filed its 10-K report for 2001.<sup>90</sup> The report stated \$107.6 million in revenue that had not been realized.<sup>91</sup> In August 2002, Gemstar filed a Form 8-K<sup>92</sup> announcing that it had overstated revenue by \$20 million and that the company was going to restate its financial results for 2001, reversing the \$20 million figure.<sup>93</sup> Gemstar also announced that Dr. Henry Yuen, the Chief Executive Officer, and Elsie Leung, the Chief Financial Officer, would not be able to certify that Gemstar's financial statements were accu-

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84. *Id.* at \*1.

85. *SEC v. Gemstar-TV Guide Int'l, Inc.*, 367 F.3d 1087, 1088 (9th Cir. 2004), *reh'g granted en banc*, 384 F.3d 1090 (9th Cir. 2004), *dist. ct. aff'd*, 401 F.3d 1031 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 416 (2005).

86. *Id.*

87. *SEC v. Gemstar-TV Guide Int'l, Inc.*, 384 F.3d 1090 (9th Cir. 2004), *dist. ct. aff'd*, 401 F.3d 1031 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 416 (2005).

88. *See SEC v. Gemstar-TV Guide Int'l, Inc.*, 401 F.3d 1031 (9th Cir. 2005) (affirming the district court's ruling), *cert. denied*, 126 S. Ct. 416 (2005).

89. *See id.*

90. *Gemstar*, 401 F.3d at 1036. A 10-K report is a report that publicly traded companies must file with the SEC annually. The report gives an overview that includes the audited financial statements of the company and the company's business and financial information. SEC, 10-K, <http://www.sec.gov/answers/form10k.htm> (last visited Jan. 2, 2007); *see also SEC v. Yuen*, No. CV 03-4376, 2006 U.S. Dist. LEXIS 33938, at \*18 (C.D. Cal. Mar. 16, 2006).

91. *Gemstar*, 401 F.3d at 1036. This announcement caused Gemstar's stock to drop by 37 percent. *Id.*

92. An 8-K report is a report that a company must file to announce an event of which the stockholders must be informed. SEC, 8-K, <http://www.sec.gov/answers/form8k.htm> (last visited Jan. 2, 2007); *see also Yuen*, No. CV 03-4376, 2006 U.S. Dist. LEXIS 33938, at \*18.

93. *Gemstar*, 401 F.3d at 1036.

rate, as required by SOX.<sup>94</sup> Then in September 2002, another Form 8-K was filed:

(1) confirming that [the corporation] had been notified by NASDAQ that its securities were subject to delisting for failure timely to file a Form 10-Q for the quarter ending on June 30, 2002; (2) that because of an unresolved dispute between Gemstar and its independent auditor KPMG, the company could not file its quarterly Form 10-Q report; and (3) that the resolution of these accounting and financial statements was “uncertain” and “unpredictable.”<sup>95</sup>

After these events, it was obvious that Gemstar was in trouble, and that something had gone wrong within the company.<sup>96</sup>

It then became clear that Yuen and Leung might have had advance knowledge of the company’s financial problems. Yuen had sold seven million shares of Gemstar stock only four days before Gemstar announced its overstatement of revenue.<sup>97</sup> Also, while Gemstar was falling apart, both Yuen and Leung were “cutting a new deal with Gemstar’s Board to ‘resign’ from their respective executive positions,” yet remain as employees in other capacities.<sup>98</sup> These attempts included negotiations for monetary compensation.<sup>99</sup> Yuen’s package included over \$29 million in cash and more than 5 million shares of restricted stock, and Leung’s package included \$8.16 million in cash, the right to purchase 1.1 million shares of common stock, and 353,680 shares of restricted stock or stock options.<sup>100</sup> The SEC then commenced an investigation into Gemstar’s revenue misstatements.<sup>101</sup>

Once the investigation was underway, the SEC asked both

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94. *Id.* at 1037.

95. *Id.* A 10-Q report is similar to a 10-K report, but is filed quarterly, instead of annually. The report includes the company’s financials and unedited financial statements. The report is filed for each of the first three quarters of the year. 10-Q, <http://www.sec.gov/answers/form10q.htm> (last visited Jan. 2, 2007); *see also* Yuen, No. CV 03-4376, 2006 U.S. Dist. LEXIS 33938, at \*18.

96. *Gemstar*, 401 F.3d at 1037.

97. *Id.*

98. *Id.* It should be noted that while the court did use the term “resign” to describe the negotiations between Yuen, Leung, and the Gemstar board, the court did place the term in quotation marks, suggesting that Yuen and Leung were at the very least being asked to resign, if not being forced to. *See id.*

99. *Id.*

100. *Id.* The packages were reported by Gemstar in an 8-K filing in November 2002. *Id.*

101. *Id.*

Yuen and Leung to put their termination payments into escrow.<sup>102</sup> Both initially declined to do so, but Gemstar informed them that the payments would be held in escrow for six months.<sup>103</sup> One day before the expiration of the six-month escrow period, the SEC petitioned to freeze Yuen and Leung's payments pursuant to section 1103 of SOX.<sup>104</sup> Thus, the issue for the court was whether these payments were "extraordinary" within the context of section 1103.

## 2. Three Approaches to Defining "Extraordinary Payments"

The three opinions of the Ninth Circuit in the *Gemstar* case—the majority, the concurrence, and the dissent—all proposed different tests for deciding when a payment is an "extraordinary payment." The majority implemented a multi-factor test to determine the definition of an "extraordinary" payment. The dissent suggested an industry comparison test, and the concurrence suggested a bright-line rule.

### a. *The majority approach: out of the ordinary*

The *Gemstar* majority first decided that "extraordinary" means "out of the ordinary," and that "out of the ordinary" means "a payment that would not typically be made by a company in its customary course of business."<sup>105</sup> The court then determined the test should be "a fact based and flexible inquiry."<sup>106</sup> Previously, the district court had looked at "[c]ontext-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," and the Ninth Circuit agreed that these factors might be used to help decide whether a payment is "extraordinary."<sup>107</sup> However, the court rejected the idea that there must be a nexus between the alleged misconduct and the payment in order for the SEC to temporarily

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102. *SEC v. Gemstar-TV Guide Int'l, Inc.*, 367 F.3d 1087, 1089 (9th Cir. 2004), *reh'g granted en banc*, 384 F.3d 1090 (9th Cir. 2004), *dist. ct. aff'd*, 401 F.3d 1031 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 416 (2005); 2 EMPLOYMENT COORDINATOR § 32:10 (Thomson West 2005) [hereinafter EMPLOYMENT COORDINATOR].

103. *Gemstar*, 367 F.3d at 1089; EMPLOYMENT COORDINATOR, *supra* note 102, § 32:10.

104. *Gemstar*, 367 F.3d at 1089-90; Rice, *supra* note 21, at 4.

105. *Gemstar*, 401 F.3d at 1045.

106. *Id.*

107. *Id.*

freeze the payments.<sup>108</sup> A nexus *may* be used to show that the payment was “extraordinary,” but is not a requirement.<sup>109</sup> Additionally, the court stated that “deviation from an ‘industry standard’—or the practice of similarly situated businesses—might also reveal whether a payment is extraordinary.”<sup>110</sup>

Even though the Ninth Circuit’s majority opinion provided some factors to use in deciding if a payment is “extraordinary,” it stressed that “the statute does not compel any specific method of making the determination but allows for the consideration of a variety of factors, as the situation may warrant.”<sup>111</sup> The majority focused on the size of the payments at issue as compared to an executive’s usual salary, and on the fact that the termination payments were different than those provided for in an officer’s employment contract.<sup>112</sup> According to the court, the termination packages of Yuen and Leung were “not business as usual.”<sup>113</sup>

*b. The dissenting approach: industry comparison*

The dissenting judge, Carlos T. Bea, suggested that the standard for determining “extraordinary payments” should require the SEC to “present evidence that a payment was extraordinary relative to payments made by other comparable companies, under circumstances which have *not* resulted in an investigation by securities agencies, but which are otherwise comparable.”<sup>114</sup> He then suggested two factors that could be used to identify a comparable company.<sup>115</sup> These factors were: (1) “size,” and (2) “the industry or market in which they do business.”<sup>116</sup> The judge also set out three factors that might be used to show “comparable circumstances.”<sup>117</sup> These factors included: (1) “the position of those whose employment is being terminated,” (2) “the length of their tenure,” and (3) “the reason their employment was terminated.”<sup>118</sup>

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108. *Id.* The court did not define “nexus,” but used “nexus” and “connection” interchangeably. *See id.*

109. *Id.*

110. *Id.*

111. *Id.* Therefore, the appeals court concluded that the district court was correct in refusing to set out a specific test to determine whether the payments made to Yuen and Leung were “extraordinary payments.” *Id.* at 1045-46.

112. *Id.* at 1046.

113. *Id.*

114. *Id.* at 1051 (Bea, J., dissenting) (emphasis added).

115. *Id.* at 1056.

116. *Id.*

117. *Id.*

118. *Id.*



The dissent argued that the majority erred in two ways.<sup>119</sup> First, the majority interpreted “‘extraordinary payments’ to mean ‘payments under extraordinary circumstances.’”<sup>120</sup> Second, by creating a test that is not based on a comparison to other companies, but is based on a comparison to the company making the payment “any payment made under any situation novel to that company is now subject to escrow.”<sup>121</sup> Judge Bea also suggested that the majority had confused its own standard by claiming that in some circumstances comparison to other industries may be appropriate, but in other circumstances it is not appropriate.<sup>122</sup> The majority opinion does not explain which circumstances require the application of which standard.<sup>123</sup>

According to Judge Bea, a comparison-based test would be more workable for the district courts to apply.<sup>124</sup> Consequently, because the SEC did not offer any proof that the payments to Yuen and Leung were not similar to other comparable companies’ termination packages, Judge Bea opined that the district court’s ruling should be reversed.<sup>125</sup>

*c. The concurring approach: a bright-line rule*

The concurring opinion by Judge Reinhardt agreed that the payments to Yuen and Leung were “extraordinary,” but did not agree with the test the majority opinion created to make that determination.<sup>126</sup> Judge Reinhardt would have held “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.”<sup>127</sup> He noted that the purpose of the Act was to temporarily freeze payments not usually made in the “ordinary course of business,” and since severance payments are never made in the “ordinary course of business,” they should al-

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119. *Id.* at 1051.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.* at 1056-57. The dissenting judge also argued that district courts have more experience applying the analysis set forth in the dissent’s test than they do the one set out in the majority’s test. *Id.*

125. *Id.* at 1057-58.

126. *Id.* at 1048 (Reinhardt, J., concurring).

127. *Id.*

ways be considered “extraordinary payments.”<sup>128</sup>

Judge Reinhardt argued the importance of a bright-line rule in order to facilitate an SEC investigation.<sup>129</sup> He also stated that the factors the majority relied on in deciding whether a payment is “extraordinary” do not suit the purpose of the Act.<sup>130</sup> He believed that, regardless of the circumstances, payments made outside of the ordinary course of business should be considered “extraordinary,” because that would serve the purpose of the Act.<sup>131</sup>

### 3. Extraordinary Expenses

Both the majority and dissenting opinions referred to three prior Ninth Circuit cases which have interpreted the phrase “extraordinary expenses.”<sup>132</sup> The majority used these cases to show that the courts used comparable reasoning in the past to interpret a phrase similar to “extraordinary payments.”<sup>133</sup> However, the dissent stated that the “extraordinary expense” cases did not apply because in those cases the court had either misinterpreted the reasoning in the case, or “the governing statute or rule of law”<sup>134</sup>

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128. *Id.* at 1049.

129. *Id.* Judge Reinhardt explained that the SEC is in the early part of its investigation when trying to place these payments into escrow, and therefore, does not have much relevant information. *Id.* (citing Floor Statement of Rep. Baker, 148 CONG. REC. H4683-01 (daily ed. July 16, 2002)). Consequently, using a bright-line rule to place these payments into escrow would help the SEC speed up their investigation.

130. *Id.* at 1050. Judge Reinhardt argued that it is possible for payments to be “extraordinary,” even if the payments are comparable to the officer’s salary, if there would not be adequate funds “to provide for disgorgement should the allegations prove true.” *Id.*

131. *Id.* Judge Reinhardt pointed out that the majority agreed with him as to the purpose of the Act, that is, “to prevent wrongdoers from depleting the corporate treasury and to ensure that there are adequate funds to provide for disgorgement should the allegations of fraud prove to be true,” and stated that the only way to conform to the purpose of the Act is to declare that all severance packages are “extraordinary payments.” *Id.*

132. *Atlanta-One, Inc. v. SEC*, 100 F.3d 105 (9th Cir. 1996); *Sousa v. Miguel*, 32 F.3d 1370 (9th Cir. 1994); *Frito-Lay, Inc. v. Local Union No. 137, Int’l Bhd. of Teamsters*, 623 F.2d 1354 (9th Cir. 1980).

133. *Gemstar*, 401 F.3d at 1045 n.2 (majority opinion).

134. The statutes and rule of law that the dissenting judge referred to are in *Sousa* and *Frito-Lay, Inc.* *Sousa*, 32 F.3d 1370; *Frito-Lay, Inc.*, 623 F.2d 1354. In *Sousa v. Miguel*, the court relied on 11 U.S.C. § 330(a)(2) (2000). *Sousa*, 32 F.3d at 1377. The court interpreted this section to mean that “trustees are not entitled to reimbursement for normal overhead expenses under § 330(a)(2).” *Id.* For the rule of law, the dissenting judge referred to *Frito-Lay, Inc.*, which cited to many different cases where “extraordinary expenses, not normal to [the company’s own] business operation” had been awarded. *See Frito-Lay, Inc.*, 623 F.2d at 1365 n.11 (citing *Mason-Rust v. Laborers’ Int’l Union, Local 42*, 435 F.2d 939, 947 (8th Cir. 1970); *Abbott v. Local 142, Journey-*

explicitly required a comparison of the “extraordinary expenses” and “the company’s past practices.”<sup>135</sup>

In *Frito-Lay, Inc. v. Local Union No. 137, International Brotherhood of Teamsters*,<sup>136</sup> the Ninth Circuit looked to the day-to-day operations of the business in examining a particular payment. Frito-Lay sued the Union, stating that the Union had forced Frito-Lay into negotiating collectively with other like companies in order to obtain a contract for its workers.<sup>137</sup> The court found the union liable, and interpreted “extraordinary expenses” when calculating damages.<sup>138</sup> The court defined “extraordinary expenses” as expenses that are “not normal to its business operation, [and] incurred as a result of the Union’s illegal strike.”<sup>139</sup> Similarly, in both *Atlanta-One, Inc. v. SEC*<sup>140</sup> and *Sousa v. Miguel*,<sup>141</sup> the court defined “extraordinary expenses” as expenses that were not part of the day-to-day expenses of that particular business.

The holdings in the three cases cited above are clear: “extraordinary expenses” are expenses that are not part of every-day

men & Apprentices of the Pipefitting Indus., 429 F.2d 790 (5th Cir. 1970); Sheet Metal Workers, Local 223 v. Atlas Sheet Metal Co., 384 F.2d 101, 109 (5th Cir. 1967); Coal Co. v. United Mine Workers of Am., 303 F.2d 39, 46 (6th Cir. 1962); Engineers v. Dahlem Const. Co., 193 F.2d 470, 472 (6th Cir. 1951); Vulcan Materials Co. v. United Steel Workers of Am., AFL-CIO, 316 F. Supp. 509, 525 (N.D. Ala. 1969)).

135. *Gemstar*, 401 F.3d at 1055 n.3 (Bea, J., dissenting). The dissent claimed that the majority misread *Atlanta-One, Inc. v. SEC*. *Id.* The dissenting judge stated that the *Atlanta-One* court did not compare the “extraordinary expense” to the day-to-day expenses of the business, “but to what the ‘reasonable’ broker might charge.” *Id.*

136. *Frito-Lay, Inc.*, 623 F.2d 1354.

137. *Id.*

138. *Id.* at 1362.

139. *Id.* at 1365 n.11.

140. *Atlanta-One, Inc. v. SEC*, 100 F.3d 105 (9th Cir. 1996). In *Atlanta-One*, the SEC brought an action against Atlanta-One, a brokerage firm, for charging customers unfair commissions. *Id.* at 106. The brokers claimed that because they incurred high expenses, the commissions were justified. *Id.* at 107. The court looked to the company’s daily expenses to see if they had incurred “extraordinary expenses.” *Id.* By looking only at the company’s past expenses, the court decided that the company had not incurred “extraordinary expenses.” *Id.* at 107-08. The court also stated that even if the company had incurred “extraordinary expenses,” it would not have been allowed to pass them on to customers through high commissions. *Id.* at 108.

141. *Sousa v. Miguel*, 32 F.3d 1370 (9th Cir. 1994). In *Sousa*, the court held that a trustee in a bankruptcy case can only be reimbursed for office expenses that are “extraordinary.” *Id.* at 1376-77. The court interpreted the relevant statute, 11 U.S.C. § 330, to mean that the trustee could not be reimbursed for “normal [overhead] expenses” but only for “extraordinary expenses.” *Id.* at 1377; *see supra* note 134. The court defined “extraordinary expenses” to mean “expenses incurred in the administration of a specific estate, not what they generally spend running their office.” *Sousa*, 32 F.3d at 1376-77.

business operations. However, two of the approaches advocated in *Gemstar* disagree with this interpretation of “extraordinary,” and take unworkable positions. The one workable approach, which is also true to the court’s past interpretation of “extraordinary,” is that of the concurring opinion. While the holding in the *Gemstar* case is correct, the majority did not fully consider the purpose behind SOX in its interpretation of “extraordinary payments.” In contrast, the concurring approach took the purpose of the Act into consideration and therefore, it is the approach courts should use when determining whether a payment is “extraordinary.”<sup>142</sup>

### III. ANALYSIS

The purpose of section 1103 of the Sarbanes-Oxley Act is to provide a mechanism for the SEC to withhold funds from potential corporate wrongdoers in order to reimburse investors for violations of securities law.<sup>143</sup> This provision has the potential to strengthen both the effect of SOX and the power of the SEC.<sup>144</sup> Consequently, it is important that the SEC be able to use section 1103 effectively. The concurring opinion in the *Gemstar* case allows this by providing an easy-to-apply bright-line rule that *all* severance payments are “extraordinary payments.”<sup>145</sup>

#### A. *An Effective Test for Section 1103 is Necessary*

The purpose of SOX is clear: to increase investor confidence in corporate America amidst failing corporate governance systems.<sup>146</sup> However, the role of section 1103 is unclear. Section 1103 states that the SEC can petition the district court for an order placing the

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142. Litigation subsequent to the Ninth Circuit’s re-hearing resulted in Yuen and Lueng’s payments being placed into escrow, and Yuen being found guilty of securities fraud, for violating “the periodic reporting, record keeping, and internal control requirements,” and making misrepresentations to auditors. *SEC v. Yuen*, No. CV 03-4376, 2006 U.S. Dist. LEXIS 33938, at \*98, \*114, \*121 (C.D. Cal. Mar. 16, 2006). After Yuen was found guilty of these violations, an additional hearing was held on the issue of remedies. *See SEC v. Yuen*, 2006 U.S. Dist. LEXIS 34759 (C.D. Cal. May 8, 2006). After the hearing on remedies, the court entered a “Final Judgment Imposing Permanent Injunction, Disgorgement, Prejudgment Interest, Civil Penalty, and Permanent Officer and Director Bar Against Defendant Henry C. Yuen.” *Id.* at \*4.

143. *See supra* notes 69-80 and accompanying text.

144. Testimony Concerning Implementation, *supra* note 30; *see also Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Sen. Tim Johnson) (stating that this legislation would strengthen the SEC).

145. *SEC v. Gemstar-TV Guide Int’l, Inc.*, 401 F.3d 1031, 1048-51 (9th Cir. 2005) (Reinhardt, J., concurring), *cert. denied*, 126 S. Ct. 416 (2005).

146. Testimony Concerning Implementation, *supra* note 30.

payments into escrow if it “appears to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise).”<sup>147</sup> This language does not give a “substantive standard that the SEC must meet in order to obtain an asset freeze.”<sup>148</sup> Consequently, the Act itself does not provide a test that the SEC can use to implement section 1103.

The importance of having an effective test might easily be overlooked because during an SEC investigation it will usually benefit a corporation to cooperate with the SEC and agree to put payments into escrow.<sup>149</sup> This is illustrated by the *Gemstar* case. Gemstar did not oppose putting both Yuen’s and Leung’s payments into escrow.<sup>150</sup> Instead, it was Yuen and Leung, individually, who brought suit against the SEC to keep their severance packages out of escrow.<sup>151</sup> Therefore, having an effective test is important because of the likelihood of litigation; even if a corporation does not oppose putting a severance payment into escrow, the executive will most likely oppose placing the payments into escrow, and will file suit against the SEC.

Additionally, a clear test for the implementation of section 1103 will allow the SEC to be more effective. Even the SEC is unclear about what exactly constitutes an “extraordinary payment.”<sup>152</sup> This uncertainty leads to unnecessary litigation and work for the SEC. A straightforward test will allow the SEC to adminis-

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147. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, tit. XI, § 1103(a), 116 Stat. 745, 807-08 (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(i) (Supp. IV 2004)).

148. Rice, *supra* note 21, at 3. This does not give the business community a standard they can use to predict whether a payment will be put into escrow. *Id.* at 4. An example of this can be seen in the *Gemstar* case. Before the SEC put Yuen and Leung’s payments into escrow, Gemstar asked the SEC for guidance in regard to the payments. *Id.* The SEC was unable to offer any guidance because they were unsure what constituted an “extraordinary payment.” *Id.*

149. *Id.* at 3. By not objecting to the SEC request to put the payments in escrow, the corporation can avoid a large expenditure during the investigation. *Id.*

150. SEC v. Gemstar-TV Guide Int’l, Inc., 401 F.3d 1031, 1034-35 (9th Cir. 2005) (majority opinion), *cert. denied*, 126 S. Ct. 416 (2005). In fact, Gemstar agreed to freeze both Yuen and Leung’s payments for six months before the SEC applied to put the payments in escrow under section 1103. SEC v. Gemstar-TV Guide Int’l, Inc., 367 F.3d 1087, 1089 (9th Cir. 2004), *reh’g granted en banc*, 384 F.3d 1090 (9th Cir. 2004), *dist. ct. aff’d*, 401 F.3d 1031 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 416 (2005); EMPLOYMENT COORDINATOR, *supra* note 102, § 32:10.

151. *Gemstar*, 401 F.3d at 1034. Yuen and Leung’s severance packages had been in escrow for six months before the SEC petitioned to place them into escrow pursuant to section 1103, because Gemstar had voluntarily placed them there at the request of the SEC. *Gemstar*, 367 F.3d at 1089; EMPLOYMENT COORDINATOR, *supra* note 102, § 32:10.

152. Rice, *supra* note 21, at 4.

ter this section effectively. By allowing for more effective implementation, SOX will have sharper teeth, and, in turn, will help deter executives from violating securities laws.

Unfortunately, neither the majority nor the dissenting *Gemstar* opinions provide guidance for the establishment of a clear and effective test. The test set forth in the majority opinion is unworkable,<sup>153</sup> and the dissenting opinion's definition of "extraordinary payment" is too narrow and places the burden on the SEC.<sup>154</sup> On the other hand, the concurring opinion creates a concise and effective test that enforces the purpose of the Act, makes the provision easy to administer, and helps deter violations of securities law.

### B. *The Majority Approach is Ineffective*

With *Gemstar*, the Ninth Circuit recognized the importance and purpose behind section 1103. Unfortunately, the majority opinion did not create a test that adheres to this purpose, thereby hindering effective implementation of section 1103. The majority opinion acknowledged the impact of corporate scandals on investor confidence.<sup>155</sup> However, after recognizing the importance of this provision, the majority then set out a "vague and multi-faceted test" that does not provide effective guidance.<sup>156</sup>

First, the majority opinion contradicts the legislative history of section 1103.<sup>157</sup> Congress's intent was to implement an effective provision that helps the SEC in preventing a CEO or CFO from taking "huge bonuses" while their company is being investigated,

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153. *Gemstar*, 401 F.3d at 1051 (Bea, J., dissenting).

154. Rice, *supra* note 21, at 7. If the SEC is unclear about the definition of an "extraordinary payment," how is the rest of the business community supposed to know how to define an "extraordinary payment?" See *supra* note 148.

155. *Gemstar*, 401 F.3d at 1035-36 (majority opinion). The court acknowledged that before section 1103 was passed, "[b]y the time the authorities ha[d] been alerted to the fraud, it [was] too late; the assets of the company ha[d] already disappeared, rendering the traditional remedies used by the Commission to rectify such wrongs—disgorgement, civil penalties, restitution, etc.—difficult, if not impossible, to pursue." *Id.* at 1035.

156. *Id.* at 1048 (Reinhardt, J., concurring).

157. See 148 CONG. REC. H4685 (daily ed. July 16, 2002) (stating that executives should not be able to take assets from a corporation when it is under investigation by the SEC); see also 148 CONG. REC. S6545 (daily ed. July 10, 2002) (stating that executives should not be able to take assets for their own benefit when they have acted improperly). Even the majority in *Gemstar* stated that "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." *Gemstar*, 401 F.3d at 1036 (majority opinion). The majority's test does not accomplish this goal.

leaving investors with nothing.<sup>158</sup> The test the majority opinion created does not effectively help the SEC reach this goal; instead, it creates an unworkable test, making it more difficult to prevent harm to investors.<sup>159</sup>

The majority's test sets out factors to help determine whether a payment is an "extraordinary payment." These factors are: (1) "the circumstances under which the payment is contemplated or made," (2) "the purpose of the payment," and (3) "the size of the payment."<sup>160</sup> These factors are subjective and are difficult to administer.<sup>161</sup> In fact, these factors are not even determinative of whether the payment is "extraordinary," they are only factors that *may* be considered when determining whether a payment is "extraordinary."<sup>162</sup>

This vague standard fails to offer any real guidance to the district courts in deciding whether a payment is an "extraordinary payment." The district courts must wade through each factor, and then decide which are the most important.<sup>163</sup> While "[s]tandards that call for an evaluation of the totality of the circumstances are, of course, well known to the law,"<sup>164</sup> where a less burdensome test coincides with the legislative intent, the more complex multi-factor test becomes unnecessary.<sup>165</sup> Because the concurring opinion pro-

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158. 148 CONG. REC. H4685 (daily ed. July 16, 2002); see *Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Sen. Patrick Leahy) ("[W]hile we can't stop greed, we can stop greed from succeeding."); see also *supra* note 155.

159. *Gemstar*, 401 F.3d at 1051 (Bea, J., dissenting).

160. *Id.* at 1045 (majority opinion).

161. See *id.* at 1048 (Reinhardt, J., concurring) (stating that the majority's test contains complex factors); see also *id.* at 1051 (stating that the majority opinion is unworkable).

162. *Id.* at 1045 (majority opinion).

163. It seems that this was not the intention of Congress when it changed the standard for the SEC to freeze payments. The pre-SOX standard for freezing payments involved a multi-factor test. See *supra* note 72. Under section 1103, Congress allows the SEC to put payments into escrow, thereby getting rid of the old multi-factor test. *Id.* The intention was clearly to make it easier for the SEC to put the payments into escrow. *Id.* It does not seem that Congress intended to get rid of one burdensome multi-factor test just to replace it with another. *Id.*

164. *Gemstar*, 401 F.3d at 1055 (Bea, J., dissenting).

165. See *id.* at 1048 (Reinhardt, J., concurring) ("I do not believe however, that Congress intended courts to apply a vague and multi-faceted test that requires consideration of the purpose, circumstances, and size of the benefits, as well as other more complex factors . . ."). In fact, the Ninth Circuit has stated in several cases concerning police officer stops that "[w]hen courts invoke multi-factor tests, balancing of interests or fact-specific weighing of circumstances, this introduces a troubling degree of uncertainty and unpredictability into the process; no one can be sure whether a particular combination of factors will justify a stop until a court has ruled on it." *United States v.*

vides a less burdensome test, which also effectively implements the intent behind the legislation, the multi-factor test of the majority is unnecessary and should be rejected.

Second, the confusion created by the majority opinion does not end with which factors should be used to evaluate a payment. It continues with the majority's statement that the payments should be compared to what a particular company does on a day-to-day basis, and then suggests comparisons to payments made by other corporations.<sup>166</sup> The dissenting opinion pointed out the confusion this could cause in implementing the majority's test: these internal and external tests could, at times, be in conflict with one another.<sup>167</sup> It is unclear which test, the internal or the external, should be favored in such circumstances. Consequently, the majority did not create a straightforward test that the SEC will be able to administer with ease. Instead, the majority's test creates the potential for conflict and thwarts the effective implementation of section 1103.

Third, the majority inappropriately defined "extraordinary" by analogy to the "extraordinary expense" cases. The majority opinion used the definition of "extraordinary" to support its theory that the correct test to use is one based on a flexible inquiry.<sup>168</sup> The court defined "extraordinary" to mean "out of the ordinary."<sup>169</sup> It then noted that "out of the ordinary" had been defined before, when the Ninth Circuit had interpreted "extraordinary expenses."<sup>170</sup> The "extraordinary expense" cases claim that "ex-

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Montero-Camargo, 208 F.3d 1122, 1142 (9th Cir. 2000) (Kozinski, J., concurring); see also *United States v. Arvizu*, 232 F.3d 1241, 1248 (9th Cir. 2000) (quoting *Montero-Camargo*, 208 F.3d at 1142); *United States v. Sigmond-Ballesteros*, 247 F.3d 943, 947 (9th Cir. 2001) (quoting *Montero-Camargo*, 208 F.3d at 1142). While here the court is dealing with securities law, and not police stops, the multi-factor test invoked still leads to "uncertainty and unpredictability." While in the above cases the court did not use a strict bright-line approach, it did recognize that only the most relevant factors should be used. *Sigmond-Ballesteros*, 247 F.3d at 947 (citing *Arvizu*, 232 F.3d at 1248; *Montero-Camargo*, 208 F.3d at 1132). In this case, getting rid of the "uncertainty and unpredictability" can easily be done by declaring every severance payment an "extraordinary payment," instead of forcing the courts to litigate the question in each instance. See Deborah Tussey, *From Fan Sites to Filesharing: Personal Use in Cyberspace*, 35 GA. L. REV. 1129, 1183 (2001) ("Multi-factor tests, applied case by case, make litigation the only venue for defining the scope of permissible use.").

166. *Gemstar*, 401 F.3d at 1045 (majority opinion).

167. *Id.* at 1055 (Bea, J., dissenting).

168. *Id.*

169. *Id.* at 1045 (majority opinion).

170. *Id.* at 1045 n.2; see also *Atlanta-One, Inc. v. SEC*, 100 F.3d 105, 108 (9th Cir. 1996); *Sousa v. Miguel*, 32 F.3d 1370, 1376-77 (9th Cir. 1994); *Frito-Lay, Inc. v. Local Union No. 137, Int'l Bhd. of Teamsters*, 623 F.2d 1354, 1365 n.11 (9th Cir. 1980).



traordinary” means expenses not part of the day-to-day running of the business.<sup>171</sup> The *Gemstar* majority used these cases to determine that “extraordinary” meant the same thing in this instance.<sup>172</sup> However, there are two problems with the *Gemstar* majority’s interpretation of these earlier cases.

To begin with, severance packages paid to high-level employees are not “business as usual.”<sup>173</sup> Therefore, such payments are never going to be “normal to its business operation.”<sup>174</sup> Also, there is no correlation between the definition of “extraordinary” that the court used and the multi-factor test that the court then implemented. Nowhere in any of the “extraordinary expense” cases did the court use a multi-factor test to decide if an expense was an “extraordinary” one.<sup>175</sup> In *Gemstar*, the majority provided no explanation as to why it jumped from the definition of “extraordinary” to deciding that a multi-factor test was necessary.<sup>176</sup> Consequently, the court’s reliance on a multi-factor test was misplaced.

While the majority’s opinion is a “middle ground”<sup>177</sup> between

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171. *Atlanta-One, Inc.*, 100 F.3d at 107; *Sousa*, 32 F.3d at 1376-77; *Frito-Lay, Inc.*, 623 F.2d at 1365 n.11.

172. *Gemstar*, 401 F.3d at 1045 n.2.

173. *Id.* at 1046.

174. *Frito-Lay, Inc.*, 623 F.2d at 1365 n.11. Examples of this can be seen in the severance packages of several CEOs. If fired, the CEO of Clear Channel Communications would receive a severance package worth \$28 million. Gordon T. Anderson, *Want a Big Payday? Get Fired: If You’re a Captain of Industry, the Day you Leave Might be the Most Profitable of All*, CNN MONEY, Apr. 30, 2003, [http://money.cnn.com/2003/04/29/pf/investing/ceo\\_severance/index.htm](http://money.cnn.com/2003/04/29/pf/investing/ceo_severance/index.htm). The CEO of Home Depot recently received “an exit package valued at about \$210 million, including \$20 million in cash severance.” Joann S. Lublin et al., *Moving Out: Behind Nardelli’s Abrupt Exit*, WALL ST. J., Jan. 4, 2007, at A1. These payments are not part of the day-to-day management of businesses. Therefore, according to the definition of “ordinary” in the “extraordinary expenses” cases, severance packages will always be “extraordinary.”

175. See generally *Atlanta-One, Inc.*, 100 F.3d 105; *Sousa*, 32 F.3d 1370; *Frito-Lay, Inc.*, 623 F.2d 1354. In all of the “extraordinary expense” cases, the court looked only at whether the expenses were part of the day-to-day running of the business. *Atlanta-One, Inc.*, 100 F.3d at 107; *Sousa*, 32 F.3d at 1376-77; *Frito-Lay, Inc.*, 623 F.2d at 1365. The courts adopted a bright-line rule: if the expenses were part of the day-to-day running of the business they were “ordinary expenses,” and if not, then they were “extraordinary expenses.” *Atlanta-One, Inc.*, 100 F.3d at 107; *Sousa*, 32 F.3d at 1376-77; *Frito-Lay, Inc.*, 623 F.2d at 1365. Using the definition of “extraordinary” in these cases would support the notion that severance packages given to executives are not part of the daily running of a business; therefore, they will always be “extraordinary.”

176. In fact, all the court stated was that “[t]he standard of comparison is the company’s common or regular behavior. Thus, the determination of whether a payment is extraordinary will be a fact-based and flexible inquiry.” *Gemstar*, 401 F.3d at 1045 (emphasis added).

177. Gilchrist, *supra* note 72, at 896.

the concurring and dissenting opinions, this alone is not a sufficient reason to use its test to interpret “extraordinary payments.” Proponents of the majority’s test state that it is “[a] flexible, multi-factor test [that] will allow the SEC to obtain a freeze where the circumstances surrounding the company under investigation indicate that investors would not otherwise be able to protect themselves.”<sup>178</sup> However, the reality is that the test may cause confusion and does not provide clear guidance to the SEC or the courts. Consequently, the majority’s test is “unworkable,”<sup>179</sup> and will not be effective in enforcing securities law.

### C. *The Dissenting Approach is Too Narrow and Burdensome*

The dissent’s test for “extraordinary payments” is a narrow test that places the burden directly on the SEC, which is contrary to the intent of Congress.<sup>180</sup> The legislative intent in passing this provision was to make it more difficult for executives to take money from a corporation while it is under investigation by the SEC;<sup>181</sup> however, the dissent’s test does not meet this objective.<sup>182</sup> The crux of the dissent’s test is whether similar companies, which have not been investigated by the SEC, have made similar payments.<sup>183</sup> This test is too narrow, and it undercuts the purpose of the Act.

The dissent’s test thwarts the effective implementation of section 1103 just as the majority’s test does. The dissent set out five

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178. *Id.*

179. *Gemstar*, 401 F.3d at 1051 (Bea, J., dissenting).

180. Rice, *supra* note 21, at 2.

181. 148 CONG. REC. H4685 (daily ed. July 16, 2002) (statement of Rep. Sensenbrenner) (explaining that the bill would make it much more difficult for executives to “pilfer” from companies under investigation); 148 CONG. REC. S6545 (daily ed. July 10, 2002) (statement of Sen. Lott) (describing the escrow provisions). This is apparent when one looks at the change in the SEC’s freeze authority from the 1934 Securities Exchange Act to the Sarbanes-Oxley Act. *See supra* note 72. The standard was much harder to meet under the 1934 Act, and included several factors. *Id.*

182. The dissent’s test “fails to focus on why a freeze is necessary in the first place,” that is, to stop executives from taking assets from the corporation when the SEC is investigating corporate wrongdoing. Rice, *supra* note 21, at 8. If the dissent’s test were put into practice, there would be little change from before SOX was implemented. Executives guilty of corporate wrongdoing would still get big severance packages, and the investors would be left with nothing. In fact, before the court’s *en banc* decision, writers for the Washington Legal Foundation wrote: “By granting *en banc* review, the Ninth Circuit has temporarily prevented section 1103 from being rendered a virtual nullity.” Michael R. Sklaire & Steven M. Goldsobel, *Federal Court Ruling will Impact SEC’s Ability to Freeze Assets Under Sarbanes-Oxley Act*, Wash. Legal Found. (Jan. 28, 2005), available at <http://www.wcsr.com/downloads/pdfs/sox012805.pdf>.

183. *Gemstar*, 401 F.3d at 1051.

factors to be considered when comparing a severance payment to payments made by similar companies.<sup>184</sup> The factors include: (1) the size of the company, (2) the type of market, (3) the employee's title, (4) how long the employee worked at the company, and (5) why the employee was terminated.<sup>185</sup> While these factors make it more likely that a severance package would be placed in escrow, their effectiveness is misleading because the factors require a comparison to companies not under investigation by the SEC.<sup>186</sup>

In addition, and more importantly, one of the purposes of section 1103 is to stop corporate executives from taking money that should go towards compensating investors.<sup>187</sup> It is hardly appropriate to compare executives under investigation for violating securities law to executives complying with the law because “[m]ost corporate executives and board members of this country work very hard, very diligently and in the highest professional manner to perform their function. This [Act] is centered at those people that really do believe that greed is good.”<sup>188</sup> The intent of the legislature

184. *Id.* at 1056.

185. *Id.* By comparing the “extraordinary payments” of companies under investigation by the SEC to companies not under investigation by the SEC, the dissenting judge misinterpreted the purpose of the statute. While the first two factors proposed by the judge, the size of the company and the type of market, give some guidance as to what a “comparable” company is, they do not provide a finite standard for the district courts and the SEC to use. *See id.*

186. During 2002 and 2003, “the average severance package at an S&P 500 company amounted to \$16.5 million.” Anderson, *supra* note 174. These numbers would be measuring sticks for whether a severance package is an “extraordinary payment.” Also, because of the recent corporate scandals, severance packages are not going “to deviate from the ‘habits and customs of the marketplace,’” and therefore, according to the dissent’s test, most severance packages will not be placed into escrow by the SEC, even though they are “extraordinary.” Rice, *supra* note 21, at 7. Based on these factors, to put a payment into escrow, the SEC would have “to conduct a full-blown evidentiary hearing.” Sklaire & Goldsobel, *supra* note 182, at 2. It is possible that the hearing could simply become “a battle of experts.” *Id.* This would make it a “question [of] . . . whether the SEC would choose to derail its investigation of corporate fraud to devote the resources necessary to prevail in a section 1103 proceeding.” *Id.*

187. *See supra* notes 69-80 and accompanying text.

188. *Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Rep. Paul Kanjorski). Hollywood has stereotyped the corporate executive as greedy. This can be seen through Michael Douglas’s character, Gordon Gecko, in the movie *Wall Street*:

The point is, ladies and gentleman, that greed—for a lack of a better word—is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms—greed for life, for money, for love, knowledge—has marked the upward surge of mankind. And greed—you mark my words—will not only save Teldar Paper, but that other malfunctioning corporation called the USA.

WALL STREET (Warner Bros. 1987). Rep. Kanjorski was suggesting that SOX is essen-

was to punish corporate wrongdoers, not to compare suspected wrongdoers to innocent CEOs when deciding if the suspected wrongdoers should have their payments put into escrow.<sup>189</sup>

The dissent's test is therefore too narrow and impedes the effectiveness of section 1103. The dissent's test would allow many "extraordinary payments" to escape the authority of the SEC. Also, the standard the dissenting judge sets—comparing companies not under investigation by the SEC with those actually under investigation—evades the purpose of the Act. Consequently, the dissent's interpretation of "extraordinary payments" is not the most effective test to use.

D. *The Concurring Approach is the Most Effective Test for Evaluating "Extraordinary Payments"*

Declaring all severance packages to be "extraordinary payments," creates a bright-line rule, making it easy for the SEC to administer section 1103 in regard to severance packages. The discussion above suggests that both the majority opinion and the dissenting opinion provide ineffective tests, leading to more litigation than is necessary.<sup>190</sup> While there are some weaknesses in the concurring opinion's test, it furthers the purpose of the Act, is easy for the SEC to administer, and is therefore the most effective means of deterring executives from taking payments after they have deceived investors.

The concurring judge, like the majority, uses the definition of "extraordinary" to support his position;<sup>191</sup> however, he does not follow up this definition with a vague "multi-faceted test."<sup>192</sup> As Judge Reinhardt states, "the payment of benefits related to that severance, is, by definition, 'extraordinary': it is uncommon, unusual, and, ultimately, not a part of the regular day-to-day business

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tially focused on the Gordon Geckos of the world, and not the majority of corporate executives who are hard-working individuals who do not believe greed is good. *Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Rep. Paul Kanjorski).

189. See 148 CONG. REC. H4685 (daily ed. July 16, 2002) (implying that once a company is under investigation by the SEC, a CEO's "pay and benefits" will be frozen automatically). Congress intended to focus on wrongdoers, not innocent CEOs, and therefore, the standard should focus on people not following the Act. See *supra* note 188 and accompanying text (discussing the fact that Congress intended for the Act to be focused on greedy people).

190. See *supra* note 186 and accompanying text.

191. SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1049 (Reinhardt, J., concurring).

192. *Id.*

of the company.”<sup>193</sup> Judge Reinhardt took the majority opinion and cut out all of the unnecessary factors and analysis to suggest that severance payments are never going to be “part of the day-to-day operations of the enterprise.”<sup>194</sup> The resulting bright-line rule will help to effectively implement the underlying purpose of the Act, will be easy for the SEC to administer, and will therefore help deter potential violators of securities regulations.

### 1. The Concurring Opinion Helps to Effectively Implement the Purpose of the Act

The concurring opinion advocated its interpretation of section 1103 with the purpose of SOX in mind.<sup>195</sup> While the majority opinion cited to the legislative history, that history was not used to create an effective test.<sup>196</sup> The Congressional Record clearly states that the purpose behind this section is to prevent executives from receiving large sums of money while the SEC is investigating their company.<sup>197</sup> The majority interpreted this to mean that they should adopt a test with different factors, placing the burden on the SEC to justify freezing the payments. However, as the concurring opinion noted, “Congress did not intend that before the SEC may freeze a severance payment . . . it must satisfy the ‘extraordinariness’ standard by presenting a substantial body of evidence to a court regarding the purpose, circumstances, and size of that particular payment.”<sup>198</sup> By putting *all* severance payments into escrow, the SEC will be able to effectively stop executives from escaping with

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193. *Id.* The three “extraordinary expenses” cases used by both the majority and the dissent support the concurring opinion’s position that “extraordinary” means something that is not part of the day-to-day business. *See Atlanta-One, Inc. v. SEC*, 100 F.3d 105, 107-08 (9th Cir. 1996) (stating that “extraordinary” means something that does not happen in the day-to-day business of a company); *Sousa v. Miguel*, 32 F.3d 1370, 1376-77 (9th Cir. 1994) (same); *Frito-Lay, Inc. v. Local Union No. 137, Int’l Bhd. of Teamsters*, 623 F.2d 1354, 1365 n.11 (9th Cir. 1980) (same).

194. *Gemstar*, 401 F.3d at 1050.

195. For a discussion of the purpose of section 1103, *see supra* notes 69-80 and accompanying text.

196. *See supra* notes 156-57.

197. 148 CONG. REC. H4685 (daily ed. July 16, 2002); 148 CONG. REC. S6545 (daily ed. July 10, 2002).

198. *Gemstar*, 401 F.3d at 1051; *see* 145 CONG. REC. H4685 (daily ed. July 16, 2002) (“Under this legislation, top executives will not be *allowed* to pilfer the assets of the company by giving themselves huge bonuses and other extraordinary payments if the company is subject to an SEC investigation.”) (emphasis added); *see also* 148 CONG. REC. S6545 (daily ed. July 10, 2002) (stating that adding the “extraordinary payment” provision would strengthen the bill, and fix some of the loopholes in the law).

huge severance packages, ensuring the return of funds to investors who have been harmed.<sup>199</sup>

## 2. The Concurring Opinion's Test is Easy for the SEC to Administer

Creating an easy-to-administer standard will allow the SEC to be more effective in carrying out the Act.<sup>200</sup> Before SOX was passed, the SEC could not get a court order to escrow payments until they had formally filed charges against a company.<sup>201</sup> The SEC had to satisfy a heavy burden in order to freeze assets.<sup>202</sup> They had to “demonstrate that the underlying claim [was] meritorious and that a legitimate concern exist[ed] that absent a freeze, the assets sought to be frozen [would] be dissipated.”<sup>203</sup> Section 1103 was intended to take the burden off the SEC.<sup>204</sup>

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199. Gilchrist, *supra* note 72, at 893; *see also* Rice, *supra* note 21, at 5 (stating that the standard should be created with the prevention of harm to the investors in mind). Also, giving high severance packages suggests that the board of directors has no control over their shareholders' funds. Michael Brush, *You're Fired. Here's Your \$16 Million*, MSN MONEY, Apr. 9, 2003, <http://moneycentral.msn.com/content/p44954.asp>. Brush also points out that many companies that have given large severance packages also have stock values that have dropped in the last few years. *Id.* Brush states that the severance packages given to the Gemstar executives were “fairly typical.” *Id.* Allowing the SEC to put all severance packages into escrow will help offset worries by investors that the CEO and the CFO of the corporation are calling the shots, and the board of directors does not have any power. The concurring opinion's test allows the SEC to “aggressively pursue” executives under investigation and return funds taken from executives to the investors. *See* Bilodeau, *supra* note 69. One of the purposes of the act was to allow the SEC to seek out executives who committed wrongful acts. *Id.*

200. *See Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Rep. Richard Shelby) (stating that “[t]o be effective, we must ensure that this legislation is properly implemented”). Bright-line rules often create a clear rule that does not result in arbitrary enforcement. *See White House Vigil for the ERA Comm'n v. Clark*, 746 F.2d 1518, 1541 n.145 (D.C. Cir. 1984) (stating that the court's ruling “[m]ost importantly . . . establishes a clear, bright line rule that does not lend itself to arbitrary or discriminatory enforcement”); *see also Osterneck v. Ernst & Whinney*, 489 U.S. 169, 176 n.3 (1989) (quoting *Budinich v. Becton Dickinson & Co.*, 486 U.S. 196, 200 (1988)) (stating that “[c]ourts and litigants are best served by the bright-line rule, which accords with traditional understanding”). While there are some critics of bright-line rules in securities law who feel bright-line rules “can be used by the clever and dishonest,” this is not the case here. *SEC v. Mut. Benefits Corp.*, 323 F. Supp. 2d 1337, 1343 (S.D. Fla. 2004), *aff'd*, 408 F.3d 737 (11th Cir. 2005). By creating this bright-line rule, the court would be creating a narrowly tailored rule that would place into escrow a particular type of payment, providing compensation for wronged investors. Also, bright-line rules are not foreign to securities law. *See infra* note 206.

201. Gilchrist, *supra* note 72, at 881.

202. Rice, *supra* note 21, at 2.

203. *Id.*

204. The dissent's approach would put the burden back on the SEC. *Id.*

Under SOX, the SEC only needs to show “that it ‘appears to the commission’ that an ‘extraordinary payment’ is likely to be made to an issuer.”<sup>205</sup> This language makes it clear that section 1103 was passed to make it easier for the SEC to put payments into escrow. The concurring opinion’s test does just this. It does not burden the SEC with a multi-factor test. It is a straightforward, bright-line rule that is simple for the SEC to apply.<sup>206</sup>

The SEC admitted before the *Gemstar* case that it “was unsure what constituted extraordinary payments.”<sup>207</sup> For this reason, the SEC was unable to give Gemstar guidance regarding whether the severance packages would be put into escrow.<sup>208</sup> This is not an effective way to implement this provision.<sup>209</sup> This uncertainty does not allow the SEC to pursue a payment freeze without wondering whether its investigation will be delayed by the need to litigate over

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205. *Id.* at 3 (quoting 15 U.S.C. § 78u-3(c)(3)(A)(i) (Supp. IV 2004)).

206. Bright-line rules are not foreign to securities law. For example, the courts have consistently held that Congress intended to implement a bright-line rule when it passed section 16(b) of the 1934 Securities and Exchange Act. 15 U.S.C. § 78p(b) (2000). Section 16(b) “contains a blanket prohibition on insiders engaging in short-selling trades—purchasing and selling (or vice versa) within a six-month window.” *Dreiling v. Kellett*, 281 F. Supp. 2d 1215, 1219 (W.D. Wash. 2003) (citing 15 U.S.C. § 78p(b)). The courts have consistently held that, with respect to this provision, Congress intended to pass a bright-line rule. *See Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973); *Colan v. Mesa Petroleum Co.*, 941 F.2d 933, 944 (9th Cir. 1991), *amended on other grounds*, 951 F.2d 1512 (9th Cir. 1991); *Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274, 1282 (5th Cir. 1986); *Segen ex rel. KFx Inc. v. Westcliff Capital Mgmt.*, 299 F. Supp. 2d 262, 267 (S.D.N.Y. 2004); *Dreiling*, 281 F. Supp. 2d at 1219. The courts have ruled that the intention of Congress is clear, and that section 16(b) should be implemented by a bright-line rule. Similarly, here Congress clearly intended that section 1103 give back to investors who have been wronged, and this is exactly what a bright-line rule would do.

207. *Rice*, *supra* note 21, at 4. This would not happen if a bright-line rule was created. Bright-line rules are known for their certainty, and:

[I]f private actors can know in advance the incidence of official intervention, they will adjust their activities in advance to take account of them. From the point of view of the state, this increases the likelihood that private activity will follow a desired pattern. From the point of view of the citizenry, it removes the inhibiting effect on action that occurs when one’s gains are subject to sporadic legal catastrophe.

Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1688-89 (1975-76).

208. *Rice*, *supra* note 21, at 4.

209. A bright-line rule would be an effective way to implement this provision. *See supra* note 200 (summarizing that bright-line rules often lead to non-arbitrary enforcement). This is further supported by the fact that “bright-line rules have grown increasingly important in corporate law over the course of this century.” Matthew G. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 BROOK. L. REV. 695, 773 (1997).

whether a payment is “extraordinary.”<sup>210</sup> The test proposed in the concurring opinion would give the SEC a clear and definitive rule as to when it can put an executive’s severance package into escrow.<sup>211</sup>

### 3. The Concurring Opinion’s Test Will Help Deter Violations of Securities Law

The test set out in the concurring opinion will also help deter potential violations of SOX. Severance packages paid to executives in America are so high that in some instances it may be more profitable for executives to get fired than to keep their jobs.<sup>212</sup> This does not encourage executives to follow the corporate governance rules within SOX. If the worst-case scenario for these executives is a violation of securities law that results in a severance package worth more than they would have received if they had stayed with the company, then there is less incentive to comply with securities law.

Section 1103 aids the SEC in enforcing other provisions within SOX. Therefore, it is important to apply an easily enforceable test to section 1103 to increase overall deterrence of securities law violations.<sup>213</sup> For example, the executive bar provision of SOX allows the SEC to bar an officer from serving on a board of directors if the SEC finds that he or she is unfit.<sup>214</sup> If it is more profitable for a CEO to be fired than to keep his job, the executive bar provision becomes meaningless. When an executive receives a huge severance package after violating securities law, it may not be important to that executive that she has been barred from serving on a board of directors, because after the large severance package, she may not have to work at all in order to maintain her existing lifestyle.

The standard used to enforce section 1103 could also have an

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210. Also, this does not help companies determine which payments they give to their officers will be put into escrow.

211. See *supra* note 200 (discussing the clarity of bright-line rules); see also Kathleen M. Sullivan, *Forward: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 62 (1992) (“[R]ules afford certainty and predictability to private actors, enabling them to order their affairs productively. Standards produce uncertainty, thereby chilling socially productive behavior.”). A bright-line rule would also reduce any arbitrariness or bias and require consistent action. See *id.* (stating the arguments for rules).

212. Russ Banham, *Pay in the Balance—Severance Packages*, THE CHIEF EXECUTIVE (Aug. 2001), available at [http://www.findarticles.com/p/articles/mi\\_m4070/is\\_2001\\_Augusta/ai\\_78805390](http://www.findarticles.com/p/articles/mi_m4070/is_2001_Augusta/ai_78805390).

213. See *Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Rep. Richard Shelby) (“[P]assing [SOX] is not enough . . . . To be effective, we must ensure that this legislation is properly implemented.”).

214. Androphy & Graham, *supra* note 18, at 67.



effect on the code-of-ethics provision of SOX. The code-of-ethics provision encourages corporations to adopt ethics rules that would address conflict of interest scenarios and encourage full disclosure of SEC filings.<sup>215</sup> The goal of the code-of-ethics section is to promote “honest and ethical” conduct.<sup>216</sup> However, because companies can tailor their codes in any way they choose, this provision has come under criticism for being ineffective.<sup>217</sup> The fear of losing a hefty severance package may encourage CEOs and CFOs to live up to the desired standard of “honest and ethical” conduct, which would compensate for the lack of deterrence within the code-of-ethics provision itself.

Also, having a strict punishment provision in SOX may help offset other weaknesses within the Act, including those found in the signatory requirements for CEOs and CFOs. The signatory requirements mandate that CEOs and CFOs certify corporate financial information.<sup>218</sup> While this was supposed to give the Act sharper “teeth,”<sup>219</sup> critics state that this provision will not stop executives from lying on SEC filings.<sup>220</sup> However, strict application of section 1103 will serve as a strong incentive for executive honesty.

While it is true that this bright-line approach may make finding CEOs to run corporations more difficult, this would only apply to executives who might be guilty of wrongdoing. Since the passage of SOX, it has become increasingly difficult for corporations to find qualified candidates to fill executive positions.<sup>221</sup> CEO candidates are hesitant to risk liability, and the risk of losing a severance package makes candidates even less willing to apply for these jobs.<sup>222</sup> However, this only will affect executives not fit to serve as officers; therefore, if the executive is careful and complies with securities law, then she has little to worry about.<sup>223</sup> Although the bright-line test can be harsh, and may result in the freezing of legitimate severance payments, it is also the most effective test. The concurring

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215. HAZEN 5th ed., *supra* note 56.

216. Testimony Concerning Implementation, *supra* note 30.

217. Note, *The Good, the Bad, and their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2134-36 (2003).

218. Testimony Concerning Implementation, *supra* note 30.

219. Gorman & Stewart, *supra* note 15, at 152.

220. Aronson, *supra* note 30, at 131-32.

221. Bilodeau, *supra* note 69.

222. Berg, *supra* note 58, at 1901.

223. See *Conference Report on Corporate Responsibility Legislation*, *supra* note 35 (statement of Rep. Paul Kanjorski) (stating the Act’s purpose “is centered around people that believe that greed is good”).

opinion's test is a straightforward, easy to administer test that helps the SEC reach its goal and increases investor confidence by allowing the SEC to effectively return funds to investors when there has been corporate misgovernance.

In any event, "innocent" severance packages put into escrow will be returned if there was no wrongdoing. Furthermore, the SEC has the discretion to not place seemingly "innocent" or "ordinary" payments in escrow.<sup>224</sup> As the concurring opinion stated, the SEC "will undoubtedly consider whether, on the basis of the limited facts available to it, a particular freeze order is necessary or desirable to protect the public interest."<sup>225</sup> Although it is true that some "innocent" payments may be put into escrow, these payments will be returned after the escrow period.

The concurring opinion's bright-line rule will make wrongdoing executives fear the consequences of violating securities law. Having a simple test might help to deter corporate officers from breaking the law, and could set higher deterrence standards for the rest of the Act. Creating a strong bright-line rule to implement section 1103 will create a more powerful and effective SEC. Consequently, this will help to effectively implement other provisions of the Act.

#### CONCLUSION

The Sarbanes-Oxley Act arose out of the corporate scandals of the 1990s with the goal of restoring investor confidence in the markets.<sup>226</sup> The investors of the 1990s differed from the investors of the past.<sup>227</sup> These newer investors were middle class Americans saving for their children's college educations and their own retirement.<sup>228</sup> The purpose of SOX was to encourage these investors to start investing in stocks again after many of them had lost money in the wake of corporate scandals.<sup>229</sup> In order to get these investors back into the market, a much stronger SEC needed to be created, an SEC with the power to punish corporate wrongdoers.

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224. SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1050 (9th Cir. 2005) (Reinhardt, J., concurring), *cert. denied*, 126 S. Ct. 416 (2005).

225. *Id.*

226. Glassman, *supra* note 33.

227. Wilkins, *supra* note 2, at 339 (citing an increase in households with investments).

228. *See id.* (stating that the stock markets are now an important part of many Americans' financial planning).

229. *See* Glassman, *supra* note 33; Wilkins, *supra* note 2, at 339-40 (implying that the purpose behind SOX was to create investor confidence in the market).

This is why the concurring opinion's test in *Gemstar*, a bright-line rule where *all* severance packages are considered "extraordinary payments," is the test that should be adopted. This test helps to give section 1103 and the SEC a provision that can easily and effectively compensate wronged investors.

Also, by implementing this bright-line rule, the SEC can easily administer section 1103. The SEC will no longer have to guess whether a certain severance package fits into the category of "extraordinary payment," cutting down on litigation time and costs.<sup>230</sup> This will allow the SEC to focus more time on the investigation rather than on securing the funds to compensate investors if wrongdoing is found.<sup>231</sup>

Furthermore, this rule will encourage potential wrongdoers to follow the requirements of SOX. The severance packages of many CEOs and CFOs are high. In some cases it is more profitable for these executives to leave the company than to continue working.<sup>232</sup> However, if the SEC can put all severance packages into escrow, then following corporate rules might become more appealing to these executives. Consequently, this will help deter executives from violating securities law in the first instance, and could possibly strengthen the SEC and other provisions within SOX.

Finally, this straightforward, bright-line test is more effective for furthering the intent of the legislature and the purpose of SOX. This test will allow the SEC to crack down on corporate wrongdoers, avoid future corporate scandals, and help investors regain and maintain confidence in the financial markets.

*Christine J. Unger\**

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230. Rice, *supra* note 21, at 4. This could also work the same way for corporations.

231. See Sklaire & Goldsobel, *supra* note 182.

232. See Anderson, *supra* note 174 (citing severance packages that range from \$9.4 million to \$82 million); Banham, *supra* note 212 (stating that it might be more profitable for some executives to get fired rather than keep their jobs).

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