

TURNING UP THE HEAT: THE SEC'S NEW TEMPORARY FREEZE AUTHORITY

The Sarbanes-Oxley Act of 2002¹ authorizes the Securities and Exchange Commission to seek a temporary order freezing “extraordinary payments” by a publicly-traded company to its directors, officers, or employees.² The Commission has sought a temporary freeze of extraordinary payments to the executives of three issuers: HealthSouth Corporation,³ Vivendi Universal,⁴ and Gemstar.⁵ This Comment analyzes the Section 1103 temporary freeze authority within the context of the Commission’s previously existing power to enforce the federal securities laws as well as to assure recovery for defrauded investors. Part I provides a general framework regarding the SEC’s ability to seek injunctions and asset freezes and its statutory authority to issue cease-and-desist orders. Part II discusses the recent extension of this authority via Section 1103, and Part III analyzes the three cases in which it has been used. Part IV summarizes thoughts about the new authority’s potential and limitations.

I. EXISTING SEC ENFORCEMENT REMEDIES

Prior to the enactment of Sarbanes-Oxley, the SEC possessed various enforcement remedies. Especially relevant to understanding the new Section 1103 authority is the Commission’s authority to seek injunctions, asset freezes, and cease-and-desist orders.⁶

A. *Injunctions*

The permanent injunction has served as the SEC’s primary enforcement mechanism since the agency’s creation.⁷ The authority is found in all six major securities laws enacted during the 1930s.⁸ These provisions authorize

1. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

2. *Id.* § 1103, 116 Stat. at 807-08 (codified as amended at 15 U.S.C. § 78u-3(c) (2002)).

3. HealthSouth, SEC Litigation Release No. 18044 (Mar. 20, 2003), <http://www.sec.gov/litigation/litreleases/lr18044.htm>.

4. Vivendi Universal, S.A., SEC Litigation Release No. 18373 (Sept. 29, 2003), <http://www.sec.gov/litigation/litreleases/lr18373.htm> [hereinafter Vivendi Release].

5. Yuen, SEC Litigation Release No. 18135 (May 13, 2003), <http://www.sec.gov/litigation/litreleases/lr18135.htm>.

6. Because of the narrow scope of this Comment, the SEC’s existing enforcement remedies are discussed only briefly. Each of the authorities cited herein provides a thorough review of the remedy in question.

7. Daniel J. Morrissey, *SEC Injunctions*, 68 TENN. L. REV. 427, 430 (2001).

8. *Id.* at 439-40; *see, e.g.*, Securities Act of 1933 § 20(b), 15 U.S.C. § 77t (2000); Securities Ex-

the Commission to seek a permanent injunction “[w]hensoever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision” of the statute.⁹

In order to obtain a permanent injunction against future violations of the federal securities laws, the SEC must “go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence.”¹⁰ Two circuits have indicated several factors which a district court should consider in determining whether there is a realistic likelihood that the defendant will continue to violate the law,¹¹ including:

1. the egregiousness of the violations,
2. the isolated or repeated nature of the violations,
3. the degree of scienter involved,
4. the sincerity of the defendant’s assurances, if any, against future violations,
5. the defendant’s recognition of the wrongful nature of his conduct,
6. the likelihood that the defendant’s occupation will present opportunities (or lack thereof) for future violations, and
7. the defendant’s age and health.¹²

Additionally, “cessation of illegal activities in contemplation of an SEC suit does not preclude the issuance of an injunction enjoining violations.”¹³ The scope of a federal court’s injunctive power is broad and can reach beyond the violations in any single case to include all future securities violations: “A federal court has broad power to restrain acts which are of the same type or class as unlawful acts which the court has found to have been committed”¹⁴ Violation of an injunction may result in criminal and civil contempt sanctions.¹⁵

change Act of 1934 § 21(d), 15 U.S.C. § 78u(d)(1) (2000).

9. 15 U.S.C. § 78u(d)(1).

10. SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 100 (2d Cir. 1978) (citing SEC v. Universal Major Indus., 546 F.2d 1044, 1048 (2d Cir. 1976); SEC v. Parklane Hosiery, 558 F.2d 1083 (2d Cir. 1977); and SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 18 (2d Cir. 1977)); see also Aaron v. SEC, 446 U.S. 680, 701-02 (1980) (discussing the scienter that needs to be proven for a permanent injunction).

11. See SEC v. Youmans, 729 F.2d 413, 415-16 (6th Cir. 1984); SEC v. Bonastia, 614 F.2d 908, 913 (3d Cir. 1980).

12. Morrissey, *supra* note 7, at 457 (citing *Youmans*, 729 F.2d at 415-16; *Bonastia*, 614 F.2d at 913).

13. SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1101 (2d Cir. 1972).

14. *Id.* at 1102 (quoting *NLRB v. Express Publ’g Co.*, 312 U.S. 426, 435 (1941)).

15. Ralph C. Ferrara et al., *Hardball! The SEC’s New Arsenal of Enforcement Weapons*, 47 BUS. LAW. 33, 94 (1991).

The SEC also may seek a preliminary injunction upon “a substantial showing of likelihood of success as to both a current violation and the risk of repetition.”¹⁶ In making this assessment, the court “should bear in mind the nature of the preliminary relief the Commission is seeking, and should require a more substantial showing of likelihood of success . . . whenever the relief sought is more than preservation of the status quo.”¹⁷ The Second Circuit has explicitly stated that a finding of irreparable harm in SEC actions is unnecessary;¹⁸ however, other circuits require such a finding, which is likely to be met where the SEC also seeks an asset freeze and makes a showing that dissipation of assets is likely.¹⁹

B. Asset Freezes

In addition to an injunction, the SEC may seek ancillary relief within a court’s general equity powers, including disgorgement, rescission of a transaction violating a federal securities law, and an asset freeze.²⁰ “Such ancillary relief is tailored to rectify past violations, to preserve the status quo pending a final adjudication of the Commission’s enforcement claims, or to prevent recidivism on the part of the defendant.”²¹ The SEC may seek a court order temporarily freezing the assets of an alleged violator of federal securities law in order “to insure that [the defendant’s assets] will be available to compensate public investors.”²²

The test for obtaining an asset freeze is merely whether the SEC is likely to succeed on the merits of its claim against the defendant.²³ This standard is similar to that of a preliminary injunction, but is weaker because it does not require proof of a likelihood of repetition.²⁴ Two rationales for the lower asset freeze standard were articulated by the Second Circuit in *SEC v. Unifund SAL*.²⁵ First, an asset freeze is designed to “facilitate enforcement of any disgorgement remedy” and thereby “assures that any funds that may become due can be collected.”²⁶ Hence, while the freeze

16. *SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998) (citing *SEC v. Unifund SAL*, 910 F.2d 1028, 1039-40 (2d Cir. 1990)).

17. *Unifund SAL*, 910 F.2d at 1039.

18. *Id.* at 1036 (citing *SEC v. Torr*, 87 F.2d 446, 450 (2d Cir. 1937)).

19. *See, e.g.*, *SEC v. Fife*, 311 F.3d 1, 8 (1st Cir. 2002) (upholding a preliminary injunction and asset freeze issued by the district court, which applied *Unifund SAL*, despite a lack of finding as to irreparable harm where there was evidence of “misappropriation of large amounts of investor funds” and “the continuing existence of the accounts and entities used to perpetrate the alleged scheme”); *SEC v. Lauer*, 52 F.3d 667, 671 (7th Cir. 1995) (noting that “[t]he preliminary injunction that the district judge issued in this case was and is essential to prevent the dissipation of assets”).

20. *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1972). *See generally* JAMES D. COX ET AL., *SECURITIES REGULATION* 879-84 (Aspen Law & Business 2001) (discussing ancillary relief).

21. COX ET AL., *supra* note 20, at 879.

22. *Manor Nursing*, 458 F.2d at 1106.

23. *Cavanagh*, 155 F.3d at 132.

24. *See id.*

25. *Unifund SAL*, 910 F.2d at 1041.

26. *Id.*; *see also Manor Nursing*, 458 F.2d at 1105-06 (discussing the reasoning behind an asset

facilitates restitution of defrauded investors' capital, it also prevents unjust enrichment of the alleged fraudster.²⁷ Second, "[u]nlike the injunction against securities law violations, the freeze order does not place appellants at risk of contempt in all future securities transactions."²⁸ Because of the different standards, "an ancillary remedy may be granted, even in circumstances where the elements required to support a traditional SEC injunction have not been established, . . . and such a remedy is especially warranted where it is sought for a limited duration."²⁹ In *Unifund SAL*, the Second Circuit reached just that result. The court denied a preliminary injunction because "the Commission ha[d] not presented . . . sufficient evidence," but approved a limited, thirty-day asset freeze because the evidence allowed "a basis to infer that the appellants traded on inside information."³⁰

C. Cease-and-Desist Orders

In 1990, Congress strengthened the SEC's enforcement authority with the Securities Enforcement Remedies and Penny Stock Reform Act (the "Remedies Act").³¹ During consideration of the new law, SEC Chairman Richard Breeden testified that the SEC "viewed injunctions as both ineffective with respect to certain offenders and particularly onerous for others."³² The new measures contained in the Remedies Act were designed to give the Commission the ability to "seek[] a remedy commensurate with the alleged violative conduct" and to enhance deterrence.³³ Significantly, the Remedies Act conferred on the Commission the power to issue both temporary and permanent cease-and-desist orders.³⁴ "A cease-and-desist order is an administrative remedy directing a person to stop illegal activity and to refrain from engaging in such activity in the future."³⁵ In conjunction with this new authority, the Remedies Act also expanded the SEC's administrative jurisdiction and authorized it "to proceed in its own administrative forum against

freeze).

27. See Michael D. Mann et al., *The Establishment of International Mechanisms for Enforcing Provisional Orders and Final Judgments Arising from Securities Law Violations*, 55 LAW & CONTEMP. PROBS. 303, 305 (1992).

28. *Unifund SAL*, 910 F.2d at 1041.

29. *Id.* (citations omitted).

30. *Id.* at 1041-43.

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

32. Ferrara, *supra* note 15, at 35 (citing Written Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs Concerning S. 647, The "Securities Law Enforcement Remedies Act of 1989," at 11 (Feb. 1, 1990)).

33. *Id.* at 33.

34. *Id.* at 56 (citing 15 U.S.C. § 78u-3 (2002)). The Remedies Act also authorizes the SEC to impose civil penalties for federal securities law violations, to require "an accounting and disgorgement in cease-and-desist proceedings," *id.* at 57, and to request a court order "prohibiting persons from serving as officers and directors of reporting companies." *Id.* at 34.

35. Dhaivat H. Shah, *The Care and Feeding of an SEC Cease-and-Desist Order: The Commission Defines Its Authority Through In the Matter of KPMG Peat Marwick, LLP*, 25 HAMLINE L. REV. 271, 272 (2002).

any person and to address any violation of any provision of the federal securities laws.”³⁶

1. *Permanent Cease-and-Desist Orders*

The Commission is authorized to enter a permanent order requiring a person who “is violating, has violated, or is about to violate” any federal securities law provision “to cease-and-desist from committing the violation or any future violation of the same provision, rule or regulation.”³⁷ The Commission must provide the person subject to the order with notice and a hearing before an administrative law judge.³⁸ The permanent cease-and-desist order was intended to be “a flexible remedy that operates similar to an injunction . . . that may be used against persons ‘who commit isolated infractions and present a lesser threat to investors.’”³⁹ One key advantage of the cease-and-desist order is that it does *not* carry with it the stigma of an injunction, which, for example, may operate to disqualify an enjoined person from serving as an officer or director of a regulated entity and thereby enhance incentives for settlement.⁴⁰ The cease-and-desist power is also potentially broad in terms of ordering a person to comply with future rules and to take actions to effectuate compliance, such as removal of a corporate officer or director.⁴¹

Obtaining a permanent cease-and-desist order requires “a lower risk of future violation than is required for an injunction.”⁴² The Commission has stated that “although ‘some risk’ of future violations is necessary, it need not be very great to warrant issuing a cease-and-desist order and that in the ordinary case and absent evidence to the contrary, a finding of past violation raises a sufficient risk of future violation.”⁴³ In considering whether to issue a cease-and-desist order, the Commission considers factors that are “akin to those used by courts in determining whether injunctions are appropriate.”⁴⁴ Moreover, a negligence standard is used to determine whether a cease-and-desist order should issue, whereas an injunction typically requires a higher degree of scienter.⁴⁵

36. Ferrara, *supra* note 15, at 57.

37. *Id.* at 56; see 15 U.S.C. § 78u-3(a).

38. Ferrara, *supra* note 15, at 57.

39. *Id.* at 58 (quoting H.R. REP. NO. 101-616, at 24 (1990)).

40. See *id.* (citing H.R. REP. NO. 101-616, at 23-24).

41. *Id.* at 58-59.

42. *KPMG, LLP v. SEC*, 289 F.3d 109, 124 (D.C. Cir. 2002). See generally Shah, *supra* note 35, at 272 (discussing the nature of the cease-and-desist authority after the SEC’s initial decision in *KPMG*).

43. *KPMG*, 289 F.3d at 124 (quoting *In re KPMG Peat Marwick LLP*, Exchange Act Release No. 34-44050, 2001 WL 223378, *6 (Mar. 8, 2001)).

44. *In re KPMG Peat Marwick LLP*, Exchange Act Release No. 34-43862, 2001 WL 47245, *26 (Jan. 19, 2001). The factors include “the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent’s state of mind, the sincerity of the respondent’s assurances against future violations, the respondent’s recognition of the wrongful nature of his or her conduct, and the respondent’s opportunity to commit future violations.” *Id.* This list is virtually identical to the first six factors listed above for injunctions. See *supra* Part I.A.

45. *KPMG*, 289 F.3d at 118-20.

2. Temporary Cease-and-Desist Orders

The Commission is authorized to seek a temporary cease-and-desist order if there is a risk of “significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest.”⁴⁶ Such an order requires the existence of a cease-and-desist order proceeding, notice, and a hearing, although an ex parte order is possible in limited circumstances.⁴⁷ The availability of the temporary cease-and-desist order is designed “to prevent investor losses . . . ‘especially when ongoing conduct places investors in continuing jeopardy.’”⁴⁸ Temporary orders may be reviewed by a federal district court.⁴⁹

The standard for issuance of a temporary cease-and-desist order is undeveloped. Despite its nearly decade-and-a-half existence, the temporary cease-and-desist authority has been of limited use.⁵⁰ However, the SEC recently approved a two-year pilot program during which the National Association of Securities Dealers (NASD) has the authority to issue temporary cease-and-desist orders.⁵¹ In order to issue a temporary cease-and-desist order, a NASD hearing panel “must find by a preponderance of the evidence that the alleged violation has occurred” and “that the violative conduct or the continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors.”⁵² Interestingly, the Commission states that “unlike a NASD issued” order, the SEC “does not have to find an actual violation before issuing a temporary cease and desist order.”⁵³ Thus, the temporary cease-and-desist order standard is lower than that of an asset freeze because it rests merely on the SEC’s allegations and requires only a showing that the allegations, if true, would result in a dissipation of assets. As discussed above, an asset freeze requires at least some

46. Ferrara, *supra* note 15, at 60 (quoting 15 U.S.C. § 78u-3(c) (2002)).

47. *Id.*

48. *Id.* at 61 (quoting H.R. REP. NO. 101-616, at 25 (1990)).

49. *Id.*

50. See *In re* A.R. Baron & Co., Exchange Act Release No. 34-37240, 1996 WL 273880, *1 (May 23, 1996) (noting that the Commission was considering a temporary cease-and-desist order “[f]or the first time”). The author found no other reported uses of the temporary cease-and-desist order.

51. Order Granting Approval to the Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3, 4, and 5 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. to Establish a Two-Year Pilot Program Relating to the Issuance of Temporary Cease and Desist Orders, Exchange Act Release No. 34-47925, 2003 WL 21229814 (May 23, 2003). The Commission received only five comments on the proposal, all of which were negative except that of the North American Securities Administrators Association. *Id.* at *16. The criticism primarily questioned the statutory authority for granting temporary ceases-and-desist power to NASD and whether leveraging NASD as an enforcement resource to this extent was warranted. *Id.* at *16-19.

52. *Id.* at *8. Most commenters urged the adoption of a higher standard—either requiring a finding of irreparable harm or a substantial likelihood of future violations. *Id.* at *24. NASD responded that upon a showing that the alleged conduct will harm investors by dissipating assets, “the potential harm to the respondent if an order is issued is overshadowed by the harm that is likely to occur if the order is not issued.” *Id.* at *25.

53. *Id.* at *32.

evidentiary showing from which “to infer” that a violation has indeed occurred.⁵⁴

The NASD has acted relatively quickly in using its new authority. On September 6, 2004, a NASD Hearing Panel granted the first temporary cease-and-desist order against a small brokerage firm, ordering it to discontinue two unregistered private placement offerings for itself, totaling \$10 million.⁵⁵ Additionally, the NASD ordered the firm to stop paying incentive bonuses for new brokers or branch managers and to collect \$2 million from its parent company and deposit the funds in escrow.⁵⁶ According to the NASD release, “[t]he panel ordered this and other relief to ‘benefit customers by protecting them from exposure to additional serious violations and further dissipation or conversion of assets.’”⁵⁷

D. Some Observations About Existing SEC Enforcement Tools

The preceding discussion of the SEC’s pre-existing enforcement remedies leads to several useful observations. Most importantly, it is apparent that the SEC possesses a broad range of devices that afford it significant flexibility in enforcing the federal securities laws in a myriad of situations. For example, the injunction is available for significant violations by recidivists, while the temporary cease-and-desist order has been approved by the SEC for use by NASD against small-time violators.⁵⁸ Moreover, where the SEC’s enforcement remedies are lacking, Congress has proven that it is willing to strengthen the Commission’s authority in order to advance investor protection (albeit in waves of activity usually in the wake of widespread losses).⁵⁹ It is also important to note that these tools are not limitless in their application. In each instance, the SEC must adhere to the requirements of due process and a judicially crafted legal standard that balances the interests of investors and those of the alleged wrongdoers.⁶⁰ As new challenges test the limits of the SEC’s enforcement authority, lessons from the application of these existing enforcement tools might suggest how the SEC will use its new Section 1103 authority, and how courts will respond.

54. See *SEC v. Unifund SAL*, 910 F.2d 1028, 1041 (2d Cir. 1990) (denying a preliminary injunction because “the Commission has not presented . . . sufficient evidence,” but approving an asset freeze because the evidence allows “a basis to infer that the appellants traded on inside information . . .”); see *supra* notes 23-30 and accompanying text.

55. National Ass’n of Securities Dealers, *NASD Granted First Temporary Cease and Desist Order to Stop Ongoing Fraud by Brokerage LH Ross* (Aug. 31, 2004) [hereinafter *NASD Granted*], available at http://www.nasd.com/web/ldcplg?IdcService=SS_GET_PAGE&nodeId=553; see also National Ass’n of Securities Dealers, *NASD Uses Cease-and-Desist Authority for First Time, Seeks Halt to Ongoing Fraud by Brokerage LH Ross* (July 27, 2004), available at http://www.nasd.com/web/ldcplg?IdcService=SS_GET_PAGE&nodeId=553.

56. See *NASD Granted*, *supra* note 55.

57. *Id.*

58. See Ferrara, *supra* note 15, at 58-59 (discussing the broad nature of cease-and-desist orders).

59. *Id.* at 60.

60. *Id.* at 64.

II. SARBANES-OXLEY FREEZE AUTHORITY

Section 1103 of the Sarbanes-Oxley Act provides, in pertinent part:

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 compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.⁶¹

The order is available “only after notice and opportunity for a hearing, unless the court determines that notice and a hearing . . . would be impracticable or contrary to the public interest.”⁶² A 45-day extension of the order is possible, but “the combined period of the order shall not exceed 90 days.”⁶³ If the person subject to the temporary freeze “is charged with any violation of the Federal securities laws before the expiration of the effective period of a temporary order . . . the order shall remain in effect, subject to court approval, until the conclusion of any legal proceedings related thereto.”⁶⁴ If no charges of federal securities violations are brought prior to the expiration of the 45- or 90-day period, the freeze terminates.⁶⁵

A. Overview

The temporary freeze authority was first proposed by President George W. Bush as part of his “corporate responsibility” initiative, launched July 9, 2002, during his address to a group of corporate leaders on Wall Street in New York City.⁶⁶ Marc Summerlin, the Deputy Director of the National Economic Council, stated the rationale for the proposal as follows:

Right now, corporate executives may try to enrich themselves once the SEC has started an investigation but before the SEC has had time . . . to file official charges against them. Under this proposal, the SEC would be able to go to court and be able to freeze extraor-

61. Sarbanes-Oxley Act § 1103 (2002) (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(i) (2002)).

62. *Id.* (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(ii)).

63. *Id.* (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(iv)).

64. *Id.* (codified as amended at 15 U.S.C. § 78u-3(c)(3)(B)(i)).

65. *Id.* (codified as amended at 15 U.S.C. § 78u-3(c)(3)(B)(ii)).

66. President George W. Bush, Remarks by the President on Corporate Responsibility (July 9, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html>.

dinary payments to executives to make sure that they don't try to steal the company assets on the way out the door.⁶⁷

Summerlin further stated that prior to this proposal, "the SEC ha[d] the ability to stop extraordinary payments once they[] filed formal charges. But it often takes them a good deal of time once they begin an investigation."⁶⁸ The new authority was designed "so the CEO can't take bonuses, can't take huge amounts of money out of the companies [sic] coffers because he knows trouble is coming down the road."⁶⁹

The freeze authority was introduced as an amendment to the Senate version of Sarbanes-Oxley⁷⁰ by Senator Trent Lott on July 10, 2002.⁷¹ In his remarks describing the amendment, Senator Lott stated that "this year we have seen just that sort of thing happening. While an investigation is underway, basically rewards were given to these corporate executives."⁷² According to Senator Lott, this authority was designed to address this area "where the law had some loopholes or where it was not timely or where it was not strong enough."⁷³ The Lott amendment creating the temporary freeze authority passed unanimously.⁷⁴

While the above remarks focus on the punishment aspect of a Section 1103 freeze with connotations related to an unjust enrichment rationale, the SEC has emphasized that the Section 1103 freeze authority enhances its "ability to obtain compensation for defrauded investors."⁷⁵ "[T]he Commission intends to use Section 1103 . . . as an adjunct to its historical basis for seeking emergency relief to preserve assets that will be used to compensate injured investors."⁷⁶ Similarly, current SEC Chairman William H. Donaldson has described Section 1103 as a "'preventive measure' [that] 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."⁷⁷ While the Section 1103 temporary freeze authority has been labeled an enforcement tool, remarks such as these suggest that its purpose is remedial. Perhaps the primary difference between the sets of remarks is spin: elected

67. White House Background Briefing on Remarks by the President on Corporate Responsibility, 2002 WL 1463080, at 2 (July 9, 2002).

68. *Id.* at 4.

69. *Id.* at 4-5.

70. S. 2673, 107th Cong. (2002).

71. 148 CONG. REC. S6524-02, S6542-43 (2002).

72. *Id.* at S6545.

73. *Id.*

74. *Id.* at S6551 (97-0 vote).

75. SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, at 1 (Jan. 27, 2003), available at <http://www.sec.gov/news/studies/sox308creport.pdf>.

76. *Id.* at 23.

77. Testimony of William H. Donaldson, Chairman, Securities and Exchange Commission, Before the Committee on Banking, Housing and Urban Affairs Concerning Implementation of the Sarbanes-Oxley Act of 2002, at 7 (Sept. 9, 2003), available at <http://www.sec.gov/news/testimony/090903tswhd.htm>.

officials such as Senator Lott wish to focus on preventing big-time executives from ripping off investors (read: voters), whereas the Commission is concerned with the practical aspects of the freeze (preserving issuer assets in the event of recovery).

B. *What Standard Applies?*

As a preliminary matter, it is not entirely clear what standard applies to the issuance of a Section 1103 temporary freeze. The likelihood-of-success standard for an asset freeze and the lower standard for a temporary cease-and-desist order—that the alleged or threatened violation would result in dissipation of assets—each have reasons for their recommendation. As discussed above, the practical rationale for a Section 1103 freeze on extraordinary payments is similar to an asset freeze in that its aim is to preserve assets for investor recovery; however, a primary purpose of a temporary cease-and-desist order is also “to prevent dissipation or conversion of assets.”⁷⁸ Section 1103’s language is also similar to the temporary cease-and-desist language: where the latter provision merely requires a determination that an alleged violation will result in dissipation of assets,⁷⁹ Section 1103 requires only a determination that “the issuer will make extraordinary payments (whether compensation or otherwise),” which logically leads to a reduction in the assets of the issuer and in potential investor recovery.⁸⁰ Moreover, neither Section 1103 nor the temporary cease-and-desist order standard requires a showing on the merits of the underlying violation.

The key difference between a Section 1103 freeze and a temporary cease-and-desist order is the requirement of federal court involvement at the phase of issuance. This renders Section 1103 more like a short-term asset freeze such as the one issued in *Unifund SAL*. A federal court will likely require an evidentiary showing in support of the freeze motion and is unlikely to grant an escrow order merely on the basis of the allegations in the SEC’s complaint. Hence, the Commission likely must present enough evidence to allow an inference of a violation. Because Section 1103 makes no mention of a finding of harm to the issuer and requires only a showing that such a payment is likely, Section 1103 likely does not require a finding of irreparable harm. Moreover, as mentioned above, payments to departing executives cause irreparable harm to investors because they reduce potential recovery.

The application of the likelihood-of-success standard presents an intriguing problem: the temporary freeze authority exists pre-complaint. Where the SEC has not filed a complaint, what is the measure of success? The SEC may be required to make some showing as to what violations it will allege in its complaint. This presents the SEC with the possibility that it

78. 15 U.S.C. § 78u-3(c)(1) (2002).

79. *Id.*

80. 15 U.S.C. § 78u-3(c)(3)(A)(i).

will reveal too much to the potential defendant. If the court accepts these potential allegations as the measure to be used, the problem is exacerbated by the fact that the SEC is still at the investigatory phase and may not yet have enough information to prove that it is likely to succeed. Additionally, where the SEC files a complaint and simultaneously requests a Section 1103 freeze, as in the case of HealthSouth, it is quite possible that the Section 1103 freeze will suffer the same fate as the asset freeze under the likelihood-of-success standard.⁸¹

III. THE SECTION 1103 FREEZE IN USE

An analysis of the three instances in which the Commission has sought to obtain a Section 1103 freeze illustrates some of the practical issues involved in wielding this new authority. It also brings to light some of the advantages and pitfalls of a temporary freeze order. In particular, the Ninth Circuit's final disposition of *SEC v. Gemstar-TV Guide International, Inc.*⁸² will likely shape the boundaries of the temporary freeze authority for the coming years.

A. SEC v. HealthSouth

On March 19, 2003, the SEC filed its complaint against HealthSouth and Richard M. Scrushy, the company's founder and long-time CEO and chairman of the board, alleging multiple violations of federal securities law.⁸³ The Commission petitioned for an emergency freeze of Scrushy's assets and escrow of extraordinary payments.⁸⁴ In support of its petition, the Commission stated:

81. See *SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298, 1330 (N.D. Ala. 2003).

82. 367 F.3d 1087 (9th Cir. 2004), *reh'g en banc granted by*, 2004 WL 2149054 (9th Cir. Sept. 24, 2004); see also Brief for Appellants, *SEC v. Yuen*, 2003 WL 22753861 (9th Cir. July 31, 2003) [hereinafter Brief for Appellants]; Brief for the SEC, *SEC v. Yuen*, 2003 WL 22753862 (9th Cir. 2003) [hereinafter Brief for the SEC]; Reply Brief for Appellants, *SEC v. Yuen*, 2003 WL 23333051 (9th Cir. 2003).

83. Complaint for Injunctive and Other Relief, *SEC v. HealthSouth Corp.*, No. CV-03-J-0615-S (N.D. Ala. Mar. 19, 2003), available at <http://www.sec.gov/litigation/complaints/comphhealths.htm>. Specifically, in paragraphs 3 and 4 of its complaint, the Commission alleges that:

3. Defendant [HealthSouth] has engaged in, and unless restrained and enjoined by this Court, will continue to engage in, acts and practices which constitute and will constitute violations of Section 17(a) of the Securities Act of 1933 . . . Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934 . . . and Rules 10b-5, 12b-20, 13a-1 and 13a-13 thereunder . . .

4. Defendant Scrushy has engaged in, and unless restrained and enjoined by this Court, will continue to engage in, acts and practices which constitute and will constitute violations of Section 17(a) of the Securities Act . . . and Sections 10(b) and 13(b)(5) of the Exchange Act . . . and Rules 10b-5 and 13b2-1 thereunder . . . and acts and practices that aid and abet [HealthSouth's] violations . . .

Id. ¶¶ 3-4 (citations omitted).

84. Plaintiff's Petition for Emergency Relief Freezing the Assets of Defendant Richard M. Scrushy and Requiring HealthSouth Corporation to Escrow Extraordinary Payments, *SEC v. HealthSouth Corp.*, No. CV-03-J-0615-S (N.D. Ala. Mar. 19, 2003) [hereinafter Plaintiff's Petition] (on file with author).

Scrusby remains in control of [HealthSouth] and continues to have the ability to direct extraordinary payments to himself and others who may have participated in the violations alleged in the complaint. [HealthSouth] is likely to make extraordinary payments, as it has in years past, as its financial results for fiscal 2002 are finalized.⁸⁵

Judge Inge Johnson issued a consent order the following day granting the SEC's petition for emergency relief and ordering HealthSouth to escrow "extraordinary payments (whether compensation, bonuses, incentives or otherwise)" to any officers or employees.⁸⁶

After hearings on the asset freeze, however, the court granted the defendant's motion to dismiss the petition for emergency relief and dissolved the asset freeze.⁸⁷ Applying *Unifund SAL*, the court concluded that there was "a thin case for any ancillary relief" based on the evidence produced during the hearings.⁸⁸ In contrast to its thorough analysis of the evidence in support of the Commission's allegations against Scrusby, the court dealt with the Section 1103 freeze summarily:

Assuming the court could intuit from "Scrusby remains in place as [HealthSouth's] Chairman of the Board and CEO and could extraordinary payments (sic)" what it is the SEC alleges defendant Scrusby might do as Chairman and CEO, the fact of the matter remains that defendant Scrusby no longer holds these positions.⁸⁹

The eventual rejection of the freeze in *HealthSouth* illustrates two important factors in Section 1103's overall effectiveness. First, timing is critical. Although seemingly counterintuitive, it is likely that where the executive is still with the company when the SEC begins its investigation and seeks to freeze extraordinary payments, as with Scrusby and HealthSouth, the freeze is less likely to be effective than when the executive is leaving the company or has already left, as with Gemstar and Vivendi, respectively. This is because the executive can merely leave, which renders extraordinary payments unlikely. Moreover, where an investigation is underway and the SEC is turning up the heat by seeking the freeze, it is likely that the executive will be forced to leave the company even before he or she can work out

85. Plaintiff's Certificate Pursuant to Rule 65(b) ¶ 7, SEC v. HealthSouth, No. CV-03-J-0615-S (N.D. Ala. Mar. 19, 2003) (on file with author); see also Plaintiff's Petition, *supra* note 84, at 3.

86. Consent Order, SEC v. HealthSouth, No. CV-03-J-0615-S (N.D. Ala. Mar. 20, 2003) (on file with author).

87. *HealthSouth*, 261 F. Supp. 2d at 1330.

88. *Id.* (quoting SEC v. Unifund SAL, 910 F.2d 1028, 1042 (2d Cir. 1990)).

89. *Id.* at 1305 (quoting Plaintiff's Petition, *supra* note 84, at 3). Scrusby was terminated by HealthSouth on March 19, 2003. *Id.* at 1314; see also Press Release, HealthSouth Corp., HealthSouth Announces Management Changes, Cooperation with Federal Investigations (Mar. 20, 1993) (announcing that Scrusby was placed on administrative leave), available at http://www.healthsouth.com/medinfo/home/app/frame?2=article.jsp,0,032003_management.

a golden parachute severance package. As discussed further in the Gemstar example, the board of a company under investigation is more likely to cooperate with SEC investigators than to offer a sweet deal to an outgoing executive who was the source of the company's current hardships.

Another key factor in the effectiveness of an 1103 freeze is the identification of specific payments. In the case of HealthSouth, the SEC merely speculated that such payments were possible. While the fact that Scrushy left HealthSouth seemed to determine the issue, the court noted later in discussing the merits of a general asset freeze that it "cannot engage in rank speculation based on allegations in pleadings" to order an asset freeze.⁹⁰ The unwillingness of a court to speculate over future extraordinary payments to executives may be even greater. For one, such payments may involve negotiation between two parties, both of whom are being investigated and likely want to maintain an appearance of propriety. Furthermore, any transfer that results from such negotiations should be detected by investigators, who could later seek a freeze on that payment. The Gemstar and Vivendi examples further illustrate this point: the SEC identified specific payments that were due to the executives under legal agreements and was successful in obtaining an 1103 freeze on them.

B. SEC v. Vivendi

On July 1, 2002, Vivendi CEO Jean-Marie Messier resigned from the company he had steered toward the brink of bankruptcy, but he did not leave empty-handed: Messier negotiated a severance package worth roughly 20.6 million euros (over \$23 million).⁹¹ After public uproar in France, Vivendi's new management sought to prevent the payment from going through because it had not been approved by the company's board; however, the agreement specified that New York state law would govern.⁹² In June 2003, a three-person arbitration panel sitting in New York ruled unanimously for Messier.⁹³ Within a month, a Paris court had frozen the severance payment at the request of France's *Commission des Opérations de Bourse* and required that shareholders give their approval.⁹⁴ In September, a New York state court affirmed the arbitration award over a motion by Vivendi to have the panel's decision vacated.⁹⁵ According to the SEC, "[a]fter negotiations between the SEC, Vivendi and Messier to reach an agreement to postpone any further collection efforts failed," the SEC filed

90. *HealthSouth*, 261 F. Supp. 2d at 1330.

91. John Carreyrou, *SEC Decision Could Imperil Messier's Push for Severance*, WALL ST. J., Dec. 22, 2003, at A1. According to this article, in his 2000 autobiography, Messier "pledged [that] he would never seek a golden parachute" and stated that "[y]ou can't have your cake and eat it too—stock options to build your wealth and a parachute in case things go badly." *Id.*

92. *Id.*

93. *Id.*

94. *Paris Court Freezes Messier's Severance*, WALL ST. J., July 10, 2003, at B6.

95. *Court Orders \$23.1 Million Be Paid to Ex-CEO Messier*, WALL ST. J., Sept. 16, 2003, at C15.

an application for a Section 1103 freeze on the payment.⁹⁶ On September 24, 2003, Judge Duffy of the Southern District of New York issued two orders granting the Section 1103 freeze on any extraordinary payments to Messier and a temporary injunction on any attempt to collect the arbitration judgment.⁹⁷

Just three months later, the SEC settled a civil fraud action against Vivendi, Messier, and the company's former CFO.⁹⁸ The agreement among the parties requires Messier to "relinquish his claim to a severance package of about []21 million [euros]," pay a \$1 million civil penalty, and a \$1 disgorgement.⁹⁹ Vivendi must pay a \$50 million civil penalty and a \$1 disgorgement.¹⁰⁰ "The Commission intends to direct that disgorgement and penalties paid in this case be paid to defrauded investors"¹⁰¹

The Vivendi-Messier example represents what could be called a "text-book" model for Section 1103.¹⁰² It shows the swiftness with which the SEC can use the authority during the investigatory phase of its case against an issuer. As the SEC notes, it also "demonstrates the Commission's commitment to use this new authority for the benefit of shareholders."¹⁰³ The separate assessment of penalties against the issuer and its former CEO illustrates the importance of Section 1103 in assuring that the issuer, who is the primary target of investors seeking recovery, will be able to satisfy any judgment. The frozen payment to Messier represents roughly half of Vivendi's fine and can essentially be transferred from the escrow account to investors or the SEC immediately. Finally, this open-and-shut use of the freeze underscores the need to identify specific payments to be frozen in order to assure effectiveness.

C. SEC v. Gemstar

In mid-August 2002, Gemstar reported that it had overstated 2001 revenues by roughly \$40 million.¹⁰⁴ On October 8, 2002, the company announced that Dr. Henry Yuen, the CEO, and Elsie Leung, the CFO, had agreed to resign from their posts in exchange for stock and "restructuring payments" totaling over \$29 million and \$7 million, respectively.¹⁰⁵ A few

96. Vivendi Release, *supra* note 4. The SEC issued a formal order of investigation on November 14, 2002. *Id.*

97. *Id.*

98. Vivendi Universal, S.A., SEC Litigation Release No. 18523 (Dec. 24, 2003), available at <http://www.sec.gov/litigation/litleases/lr18523.htm>.

99. *Id.*

100. *Id.*

101. *Id.*

102. "This action represents the first resolution of a Section 1103 action" Press Release, SEC, Commission Settles Civil Fraud Action Against Vivendi Universal, S.A., Its Former CEO, Jean-Marie Messier, and Its Former CFO, Guillaume Hannezo (Dec. 23, 2003), available at <http://www.sec.gov/news/press/2003-184.htm>.

103. *Id.*

104. SEC v. Gemstar-TV Guide Int'l, Inc., 367 F.3d 1087, 1089 (9th Cir. 2004).

105. Press Release, Gemstar-TV Guide, Gemstar Approves Management Changes; Jeff Shell to

days later, the SEC launched a formal investigation into the company and its management.¹⁰⁶ On November 6, 2002, one day before the management changes were to be confirmed publicly, Gemstar agreed, at the SEC's request, to place the restructuring payments to Yuen and Leung in escrow for six months.¹⁰⁷

1. District Court Proceedings

On March 31, 2003, Yuen and Leung sued the SEC, seeking an injunction dissolving this "extra-judicial escrow."¹⁰⁸ In their complaint, Yuen and Leung claim that they were due the restructuring payments after agreeing to resign from the company before the end of their employment contracts, but that the SEC intimidated Gemstar's board into agreeing to escrow the payments, thus circumventing Section 1103.¹⁰⁹ Yuen and Leung's motion to dissolve the escrow was ultimately rejected by the district court, and on May 12, 2003, Judge W. Matthew Byrne entered a Section 1103 order wherein the Commission and Gemstar agreed that "no future extraordinary payments shall be made to any Gemstar director, officer, partner, controlling person, agent, or employee."¹¹⁰ On June 19, 2003, the SEC filed a civil securities fraud action against Yuen and Leung alleging that they had engaged in several complex schemes that caused Gemstar to overstate revenues by roughly \$223 million over three years.¹¹¹

To this point the Gemstar example shows the extent to which the SEC may be effective in imposing hardship on a potential defendant without federal court involvement. It is fair to say that despite its inclusion in the provision conferring the Commission's cease-and-desist authority, Section 1103 of Sarbanes-Oxley does not authorize unilateral SEC action. Rather, Section 1103 specifically requires judicial oversight of a temporary freeze and allows for the entry of a freeze order "*only* after notice and opportunity for a hearing, *unless the court determines* that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest."¹¹² Here,

Become CEO, available at http://www.gemstartvguide.com/pressroom/display_pr.asp?prId=131.

106. Press Release, Gemstar-TV Guide, Gemstar Announces Transition of SEC Investigation to Formal Status, available at http://www.gemstartvguide.com/pressroom/display_pr.asp?prId=132.

107. See *Gemstar-TV Guide*, 367 F.3d at 1089.

108. Complaint for Injunctive and Declaratory Relief, *Yuen v. SEC*, No. CV 03-2219, 2003 Extra LEXIS 13, *1-*2 (C.D. Cal. Mar. 31, 2003).

109. *Id.* at *12-*13.

110. *In re SEC v. Yuen*, 2003 U.S. Dist. LEXIS 8707, *2-*3 (C.D. Cal. May 12, 2003).

111. Complaint for Violations of the Federal Securities Laws, *SEC v. Yuen*, No. CV 03-376 ¶ 3 (C.D. Cal. June 19, 2003), available at <http://www.sec.gov/litigation/complaints/comp18199.pdf>. "Since Yuen and Leung resigned . . . Gemstar has restated or reversed approximately \$357 million in revenue . . ." *Id.* ¶ 7. The Commission claims that Yuen and Leung benefited from the fraud "[b]ecause their compensation was tied to Gemstar's reported financial results." *Id.* ¶ 8. The SEC seeks a permanent injunction against both Yuen and Leung from additional securities law violations, an order prohibiting them from serving as officer or director of an issuer, disgorgement of "ill-gotten gains," and civil penalties. *Id.* at 34-35 (Prayer for Relief).

112. Sarbanes-Oxley Act § 1103 (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(ii) (2002)) (emphasis added).

however, the SEC succeeded in obtaining an effective freeze on the payments “owed” to Yuen and Leung for nearly six months without federal court sanction due to the cooperation afforded by Gemstar’s board. Moreover, the court’s freeze order of May 12, 2003, preceded the Commission’s complaint by over a month. This example also shows that a court may be more likely to authorize a freeze where the funds at issue have already been placed in escrow by the time the court rules on the Commission’s actual Section 1103 motion.

2. *The Parties’ Arguments on Appeal*

Yuen and Leung filed an appeal of the district court’s escrow order on July 31, 2003.¹¹³ Their two primary arguments were: (1) that the escrowed payments had already been paid to them into separate accounts, and (2) that the restructuring payments were not “extraordinary payments” subject to a Section 1103 freeze.¹¹⁴ These contentions are useful in analyzing the potential applications of the Section 1103 freeze authority by answering the following questions: *To whom* does the freeze apply? *When* must it be sought? And finally, *what payments* can be frozen?

a. *To Whom and When?*

Pointing to the requirement that the SEC find “it likely that the ‘issuer will make extraordinary payments,’” Yuen and Leung made two textual arguments.¹¹⁵ First, they contended that Section 1103 applies only to issuers and therefore not to individuals such as themselves.¹¹⁶ While correct in that the statute authorizes a court order “requiring the issuer to escrow . . . payments,”¹¹⁷ it is likely that Section 1103’s scope matches that of the temporary cease-and-desist authority, which extends to persons required to be registered with the SEC, including issuers, and persons associated with a registered entity, which would include the issuer’s CEO and CFO.¹¹⁸

Their second textual argument was that Section 1103 applies only to potential future payments and not those that had already been made by the company.¹¹⁹ While this particular issue depends on the interpretation of the agreement providing for the segregated accounts,¹²⁰ Yuen and Leung’s line

113. See Brief for Appellants, *supra* note 82.

114. *Id.* at *15-*16. Yuen and Leung also contend that Section 1103 is void for vagueness; that Section 1103 constitutes an unreasonable seizure in violation of the Fourth Amendment; and that 1103 was applied retroactively to payments that were essentially accrued compensation. *Id.* However, these arguments are beyond scope of this Comment. The Ninth Circuit also did not address these arguments. See *Gemstar-TV Guide*, 367 F.3d at 1088.

115. Brief for Appellants, *supra* note 82, at *27 (quoting 15 U.S.C. § 78u-3(c)(3)(A)(i) (emphasis omitted)).

116. *Id.*

117. Sarbanes-Oxley Act § 1103 (codified as amended at 15 U.S.C. § 78u-3(c)(3)(A)(i)).

118. See Ferrara, *supra* note 15, at 60-61.

119. Brief for Appellants, *supra* note 82, at *27.

120. Yuen and Leung claimed that the payments had been paid to them per an agreement with the

of reasoning serves to reiterate a point made with the HealthSouth example: timing of the Section 1103 freeze is critical to its success. The timing issue here, however, is different from the one raised earlier in that it illustrates what could happen if the SEC is too late in seeking a freeze. The SEC essentially has to know beforehand when payments will be made in order to freeze them. With Gemstar, the SEC caught the payments while they were being negotiated out the door. With HealthSouth, however, the SEC was less fortunate since no payments were readily anticipated, although the risk of payment to Scrusby essentially went out the door when he did.

b. Extraordinary Payments

The crux of Yuen and Leung's opposition to the Section 1103 freeze was that the payments at issue were not extraordinary. In support of this argument, they made two key contentions. First, they claimed that the legislative history of Sarbanes-Oxley indicates that a Section 1103 freeze is appropriate only as applied to improper or unwarranted payments.¹²¹ Yuen and Leung stated that "[t]he District Court plainly misinterpreted this legislative history when it chose not to consider the specific sources and makeup of the payments at issue to determine whether the payments to Yuen or Leung were 'increased payments,' were 'improper payments,' or constituted the 'pilfering' of Gemstar assets."¹²² After pointing out that the payments were negotiated, actually resulted in reduced payments to the former CEO and CFO, and were decided upon "before the SEC even commenced its formal investigation," they concluded that "it is clear that the Restructuring Payments were not the sort of illegitimate grab for funds that Section 1103 was designed to prohibit."¹²³

The SEC focused on the plain language of the statute and encouraged a broad and flexible interpretation.¹²⁴ The Commission pointed out that Section 1103 "explicitly states that 'extraordinary payments' may include 'compensation.'"¹²⁵ Additionally, the SEC took issue with a reading of the statute that limits it "to payments made without a board of director's authorization" because the text of the statute makes no mention of exempting board-approved payouts.¹²⁶ Addressing the appellants' legislative history

company and were merely being held in separate accounts. *Id.* Moreover, they asserted that "[u]nder no circumstances was the money to revert to Gemstar." *Id.* at *28. Not surprisingly, the SEC viewed the agreement differently and argued that "the funds placed into the segregated account . . . [were to] be retained by [Gemstar] and remain [Gemstar] property until" an agreement was reached by the SEC and Yuen and Leung or the expiration of the six-month period. Brief for the SEC, *supra* note 82, at *30-*31.

121. Brief for Appellants, *supra* note 82, at *30-*31.

122. *Id.* at *31.

123. *Id.* at *32.

124. Brief for the SEC, *supra* note 82, at *34.

125. *Id.* at *37.

126. *Id.*

argument, the SEC advocated an interpretation of “improper” as meaning “unfair and unethical” rather than “without authorization.”¹²⁷

Yuen and Leung are correct in that the political focus of Sarbanes-Oxley, and Section 1103 in particular, has been on punishing wrongdoers who take advantage of the investing public. However, this argument does not take into account the practical purpose of a Section 1103 freeze: to assure investor recovery from an issuer that has violated the federal securities laws. In that context, the merits of a Section 1103 freeze have little to do with the motives behind any such payments. Rather, a freeze on extraordinary payments seems warranted regardless of whether they were properly earned or were the result of outright pilfering. This is similar in effect to an asset freeze, which may issue where an inference of wrongdoing exists even though in most cases not all, or even most, of the frozen assets were obtained as a direct result of the alleged violation. Moreover, in many instances, the CEO of an issuer may be awarded a compensation package—consisting of a large salary, a favorable bonus structure, and a golden parachute—that is not necessarily in the shareholders’ best interests at a time when the company’s shares are soaring and the shareholders have little reason to object. The broader point is that the political rhetoric in support of Section 1103 has little bearing on how the SEC will use the freeze as an adjunct to a traditional asset freeze and other equitable relief, which is not only to prevent future harm to the shareholders but also to assure compensation for past harm.

Yuen and Leung’s other primary contention, and the basis of the Ninth Circuit’s decision vacating the escrow order discussed below, was that the circumstances surrounding the payments show that they were not extraordinary.¹²⁸ The district court’s finding that the restructuring payments were extraordinary payments relied on three circumstances: “(i) the payments were the product of substantial negotiation, (ii) the payments were connected to Yuen and Leung’s departure from Gemstar and the related restructuring, an event which Gemstar reported in an 8-K filing and (iii) the payments were ‘large.’”¹²⁹ As to the first point, Yuen and Leung argued that the extensive negotiation of the payments “demonstrates that the payments were carefully considered.”¹³⁰ They also noted that the court “made no finding that the payments . . . were not believed to be in the best interests of Gemstar by its Board, the Special Committee, and outside counsel.”¹³¹ Secondly, Yuen and Leung pointed out that “[a] onetime payment of an existing entitlement to a departing senior executive is a wholly ordinary aspect of American corporate life.”¹³² Finally, they contended that their size “says

127. *Id.* at *39 n.28.

128. Brief for Appellants, *supra* note 82, at *32.

129. *Id.*

130. *Id.* at *32-*33.

131. *Id.* at *33.

132. *Id.* at *34.

nothing about the ordinary or extraordinary nature of the payments” in the absence of evidence of Yuen’s and Leung’s pre-existing entitlements or other “severance payments paid to similarly situated departing CEOs and CFOs.”¹³³

The SEC countered that the five-month negotiation process, during which Yuen and Leung, Gemstar’s Board, and the Special Committee were represented by separate counsel, was extraordinary.¹³⁴ The Commission also pointed to the sheer size of the payment amounts—totaling over \$29 million to Yuen and \$8 million to Leung—as “clearly extraordinary.”¹³⁵ In response to the appellants’ three contentions discussed above, the SEC argued that “if Section 1103 did not . . . apply to payments approved by a corporation’s board, the statute would provide almost no assistance to shareholders.”¹³⁶ The SEC next contended that “Section 1103 does not carve out an exception for pre-existing contracts.”¹³⁷ Finally, the SEC contended that the circumstances and absolute size of the payments alone are sufficient to support a finding that the payments were extraordinary.¹³⁸

3. *The Ninth Circuit’s Initial Decision*

In a 2-1 decision, a panel of the Ninth Circuit vacated the district court’s escrow order “[b]ecause there was no evidence as to what would be an ordinary payment under comparable circumstances.”¹³⁹ The majority disagreed with the district court’s findings that the payments were extraordinary on the three grounds discussed above. As for the extensive negotiation of the payments, the panel concluded that the involvement of many sophisticated parties over five months did not indicate that the payments were extraordinary: “[F]or all the persons involved in the negotiations, not one presented evidence . . . that the period or mechanics of the negotiations were out of the ordinary in view of the circumstances.”¹⁴⁰ Next the court determined that while the \$37 million payments “are ‘extraordinary payments’ in relation to what federal judges are paid,” the size of the payments alone is insufficient for a finding that they were extraordinary.¹⁴¹ Instead, the district court should receive evidence “of what similarly placed officers and board members of corporations of similar revenues and worth are paid upon termina-

133. *Id.*

134. Brief for the SEC, *supra* note 82, at *39-*40.

135. *Id.*

136. *Id.* at *40.

137. *Id.* at *40-*41.

138. *See id.* at *42.

139. *SEC v. Gemstar-TV Guide Int’l, Inc.*, 367 F.3d 1087, 1088 (9th Cir. 2004). Judge Carlos T. Bea and Judge Johnnie B. Rawlinson voted to vacate, *id.*, while Judge Stephen Trott dissented. *Id.* at 1095-1108 (Trott, J., dissenting).

140. *Id.* at 1092-93. The panel also stated that “[w]hile common experience of the district court might help to determine what is the usual way to negotiate the termination of a lawyer at a law firm or a staff member of the court, common experiences of this kind do not aid judgment in the circumstances of Appellants’ termination at Gemstar.” *Id.* at 1093.

141. *Id.*

tion.”¹⁴² Finally, the court dismissed the Form 8-K filing for payments “approximating 15% of the previous year’s revenues” as unsurprising “[i]n this era of heightened corporate vigilance,” and determined that “a discretionary corporate disclosure is not an admission that the company has paid an ‘extraordinary’ amount.”¹⁴³

The court determined that “[t]he bases used by the district court to judge the negotiations, the payments, and the filing were ‘irreducibly subjective.’”¹⁴⁴ The panel analogized the inquiry into whether payments to executives are “extraordinary” to other instances in which a court must determine whether an amount is superlative, for example, the reasonableness of attorney’s fees,¹⁴⁵ extraordinary probate fees,¹⁴⁶ and “ordinary and necessary” business expenses.¹⁴⁷ In these cases as well as in the Section 1103 inquiry, whether “the case at hand falls outside the bounds permitted in the comparison cases” is the critical inquiry.¹⁴⁸ In conclusion, the court held that “[n]ot mere government assertion, but proof by admissible objective evidence of what is ordinary is necessary to allow a court to determine what is extraordinary.”¹⁴⁹

In his dissent Judge Trott sided with the SEC in much the same way that the majority sided with Yuen and Leung, advocating a straightforward interpretation of Section 1103 informed by its purpose:

“Extraordinary” simply means, in plain language, out of the ordinary. In this context—and the *context* is the key—“out of the ordinary” simply means a payment made not in the customary or normal pursuit of the regular trade or business of the issuer *under scrutiny*, but in response to an irregular or abnormal demand of the moment that reasonably appears to have been provoked or motivated by or connected to the possible violations of securities laws that triggered the investigation.¹⁵⁰

In his view, “the measure of ‘extraordinary’ is what ordinarily goes on in the process of the issuer’s business”¹⁵¹ In this case, Judge Trott believed that there was significant evidence that the payments were extraordinary in light of Gemstar’s ordinary business and the circumstances involved: the payments totaled five and six times Yuen’s and Leung’s base salary, respectively, and consisted of bonuses derived from fraudulently inflated financial results, which precipitated the payees’ ouster, a significant

142. *Id.* at 1094.

143. *Id.*

144. *Id.* (quoting *Nunez v. San Diego*, 114 F.3d 935, 943 (9th Cir. 1997)).

145. *Id.* at 1095 n.7.

146. *Id.*

147. *Id.* at 1095.

148. *Id.*

149. *Id.*

150. *Id.* at 1106 (Trott, J., dissenting).

151. *Id.* at 1107 (Trott, J., dissenting).

fall in the company's stock, and an ongoing securities fraud investigation.¹⁵² Finally, Judge Trott highlighted the overarching purpose of Section 1103: to "ensure[] that recovery by way of disgorgement, etc., is effective rather than empty."¹⁵³

On September 24, 2004, the Ninth Circuit voted to rehear *SEC v. Yuen* en banc and vacate the panel's decision.¹⁵⁴ As of this writing, the appeal remains pending.¹⁵⁵

4. Extraordinary Payments Redux: When What Is Extraordinary Really Is Extraordinary

The arguments regarding whether the restructuring payments to Yuen and Leung are "extraordinary" per Section 1103 highlights the tension between the competing aims of using the temporary freeze authority as an enforcement tool and using it as a remedial tool. For example, Yuen and Leung urge that the payments are not extraordinary because they were "carefully considered," authorized by Gemstar's Board, and resulted from a contractual entitlement—all of which provide an imprimatur of acceptable, and therefore non-sanctionable, corporate conduct. The Commission, on the other hand, relies primarily on the "sheer size" of the payments and dismisses the corporate formalities as irrelevant because in their view, one can posit from their arguments, Section 1103's entire purpose is to keep money that could be used to compensate investors from going out the door. As discussed above, understanding Section 1103 within the context of the SEC's pre-existing enforcement remedies (a description which reinforces this dichotomy) supports the SEC's position.

The opinion of the majority of the Ninth Circuit panel emphasizes a related point: that the legal standard applied significantly affects the efficacy of the remedy. While the standard for issuance of an escrow order is not directly affected by what legal test is used for determining whether a payment is extraordinary, requiring proof of what is "ordinary" and not allowing the circumstances to speak for themselves implicitly increases the burden on the SEC to prove that the payments are the product of a fraudulent scheme. This would be especially true where a comparison of the payments at issue to payments made by other companies to departing executives reveals no significant deviation on the part of the issuer under investigation. To offset such a showing, it is likely that the Commission would be compelled to reveal a significant amount about the underlying violations in order to justify the freeze—a de facto standard that begins to border on the likelihood-of-success test for an asset freeze. Moreover, the majority's re-

152. See *id.* (Trott, J., dissenting).

153. *Id.* (Trott, J., dissenting).

154. *SEC v. Yuen*, 2004 WL 2149054 (9th Cir. Sept. 24, 2004) (en banc).

155. This section of the Comment was finalized prior to the Ninth Circuit's revised opinion, discussed below. See *infra* note 157 and accompanying text.

quirement that the payments and the circumstances surrounding them be shown to be extraordinary relative to other ordinary payments undercuts the purpose of Section 1103 because it fails to focus on why a freeze is necessary in the first place: to prevent pilfering and to secure investor recovery where an investigation into wrongdoing is already underway.

In light of Section 1103's remedial purpose and the language of the statute, it seems clear that the payments to Yuen and Leung are "extraordinary payments." While that term implies a one-time largess, as the Commission noted, Section 1103 specifically mentions compensation. Section 1103 also contemplates the possibility that multiple payments to multiple insiders may be frozen—an authority that theoretically extends to what may truly be described as ordinary corporate practice, such as incentive bonuses for management. While "extraordinary" denotes that the circumstances of such payments are important, extensive negotiation and board approval of payments like those to Yuen and Leung are far from atypical. Therefore, it is of little help to require a comparison across issuers which would potentially pressure the SEC to make a showing as to the underlying fraudulent conduct. Finally, it should be remembered that an existing SEC investigation is a necessary predicate to a temporary freeze. It is not unreasonable, especially in light of the remedial purposes of Section 1103, to determine that any sizeable payments made during an SEC investigation are extraordinary, regardless of whether they were negotiated, approved by the Board, or otherwise routine.

IV. CONCLUSION

As a significant increase in the SEC's enforcement power, Sarbanes-Oxley will likely be discussed, analyzed, and criticized for years to come.¹⁵⁶ This Comment has argued that Section 1103 is a handy addition to the Commission's existing authority to seek injunctive and ancillary relief, including disgorgement, but that it is likely to be effective only where the SEC, during an investigation, learns that one of the issuer's executives is planning to take flight with a golden parachute. Because of this narrow window, timing and the ability to identify specific payments are critical to the success of a Section 1103 freeze.

Despite these hurdles, the Section 1103 temporary freeze authority shows promise in bringing an issuer to the negotiation table before litigation, especially when new executives are willing to cooperate with the Commission in freezing payments to former executives in hopes of lessening the issuer's own penalty. Courts may also prefer a targeted Section 1103 freeze to a general asset freeze due to concern about disrupting an issuer's business. Finally, the SEC can expect to find significant resistance from

156. See, e.g., Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1091 (2003).

payees with regard to what exactly makes a payment “extraordinary.” Given the statutory language that specifically includes compensation and the provision’s primarily remedial goal, it is likely that the SEC will not have difficulty proving that a payment is extraordinary in the circumstances which are most likely to give rise to the need to invoke Section 1103. As a result, the SEC is likely to find the provision effective in assisting investor recovery in a handful of high-profile cases, but its ability to supplement the Commission’s existing enforcement authority may be limited.

POSTSCRIPT

On March 22, 2005, after the finalization of the above Comment, the Ninth Circuit issued a revised opinion.¹⁵⁷ Judge Trott, now writing for the majority, articulated the following test for the issuance of a Section 1103 order:

“Extraordinary” means, in plain language, out of the ordinary. In the context of a statute aimed at preventing the raiding of corporate assets, “out of the ordinary” means a payment that would not typically be made by a company in its customary course of business. The standard of comparison is the company’s common or regular behavior.¹⁵⁸

The court delineated several factors relevant to this determination: the circumstances, purpose, and size of the payment; any “nexus between the suspected wrongdoing and the payment itself”; and a comparison of the payment to industry custom.¹⁵⁹ The court affirmed the district court’s issuance of the temporary freeze order based on the complicated five-month negotiation process that preceded the payments, the fact that the payments were essentially made in exchange for the termination of Yuen and Leung, the multiple of the payments to Yuen and Leung’s base salaries (five and six times, respectively), and a determination that the severance payments were greater than Yuen and Leung would have been entitled to under their existing employment agreements.¹⁶⁰ Finally, the court agreed that because Yuen and Leung’s bonuses were directly tied to Gemstar’s performance, which was allegedly fraudulently overstated, the nexus factor supported the freeze.¹⁶¹

The concurring judges would have adopted a much broader test: “[A]ll severance packages due top corporate officers and officials, and any other substantial non-routine payments to which they may be entitled, constitute

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

158. *Id.* at 1045.

159. *Id.*

160. *Id.* at 1046.

161. *Id.* The court also allowed an adverse inference from Yuen’s assertion of his Fifth Amendment rights during the SEC’s investigation of his compensation. *Id.*

'extraordinary payments'"¹⁶² Their main point of disagreement with Judge Trott is whether an analysis of the circumstances of the payment at issue and the nexus element are necessary or even relevant. Preferring a bright-line rule that would not burden the SEC in the early stages of an investigation when it is most likely to seek a Section 1103 order, Judges Reinhardt and Graber would find that "a severance payment is an extraordinary payment regardless of the circumstances."¹⁶³ In his dissent, Judge Bea disagreed with the majority's construction of Section 1103. In his view, "Section 1103 empowers the SEC to escrow 'extraordinary payments,' not payments made under extraordinary circumstances, particularly where 'extraordinary circumstances' means little if anything more than that the company is under investigation for securities violations."¹⁶⁴ To determine whether the payments are extraordinary, Judge Bea would conduct a company-to-company comparison, wherein the payments at issue would be compared to payments made to similarly-situated employees at similar firms *not* under investigation by the SEC.¹⁶⁵ Presumably, under this test, if the suspect payments differ substantially from the comparison payments, then they are extraordinary.

Judge Trott's standard is a common-sense middle ground that gives effect to both the remedial purpose of Section 1103 and the clear language of the statute.¹⁶⁶ While Congress's intent was to prevent unjust enrichment, it seems clear—as this Comment has advanced—that the SEC intends to use its temporary freeze authority as an adjunct to its existing ability to obtain compensation for defrauded investors. A flexible, multi-factor test 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. Judge Trott's approach also does not sweep too broadly by bringing in severance payments without first determining whether they are made under circumstances which make them extraordinary.¹⁶⁷ Finally, the multi-factor test gives effect to the key modifier, extraordinary, without limiting it to the most egregious situations where an executive negotiates a golden parachute that is more golden than those given by comparable companies.

One issue not explicitly addressed by the *Gemstar* court is the standard that should apply to the issuance of a Section 1103 temporary freeze.¹⁶⁸ The court noted that excerpts from the declaration prepared by the Commission

162. *Id.* at 1048 (Reinhardt, J., concurring). Judge Reinhardt was joined by Judge Graber. *Id.*

163. *Id.* at 1050 (Reinhardt, J., concurring).

164. *Id.* at 1060 (Bea, J., dissenting). Judge Bea wrote the initial Ninth Circuit majority opinion. *See SEC v. Gemstar-TV Guide Int'l, Inc.*, 367 F.3d 1087 (9th Cir. 2004).

165. 401 F.3d at 1056 (Bea, J., dissenting). This is a more detailed statement of the standard which Judge Bea articulated in the initial Ninth Circuit decision in this case. *See supra* note 142.

166. *See supra* Part III.C.4.

167. Although, as suggested in this Comment, this interpretation is plausible. *See supra* Part III.C.4. Perhaps the ultimate difference between these approaches is the importance of the amount of the payment at issue.

168. *See supra* Part II.B.

in support of the temporary freeze order “sound much like the allegations of probable cause to be found in a standard search warrant.”¹⁶⁹ However, the SEC’s argument focused on the circumstances surrounding the payments, not the fraud itself. Hence, it is likely that a mere showing that the payments will be made is sufficient to obtain a freeze without having to prove a likelihood of success on the merits. The “nexus” factor in the majority test described above, however, may increase the SEC’s burden in this regard.

Wesley Bowen Gilchrist

169. 401 F.3d at 1039. These excerpts provide detailed information on testimony, subpoenas, and other evidence, and present an overview of the factual evidence. *See id.* at 1039-41. The SEC also submitted a memorandum of law that advanced the same arguments made on appeal. *See id.* at 1041-44; *supra* notes 124-127 and 134-138.

