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Expert Analysis

Should a Defendant Be Forced To Disgorge What He Never Possessed?

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To the considerable arsenal of remedies already possessed by the Securities and Exchange Commission the U.S. Court of Appeals for the Second Circuit has recently added another: The SEC is authorized to seek disgorgement of illegal profits that a defendant never personally possessed. The Second Circuit, in *SEC v. Contorinis*,[1] affirmed the district court's imposition of an order that the defendant must disgorge over $7 million in profits from an insider trading scheme that only benefited the fund he managed. The court rejected the defendant's argument that any disgorgement should be limited to less than $500,000, the amount by which his compensation was inflated due to the scheme. In the wake of *Contorinis*, the SEC can not only seek civil penalties,[2] bar orders,[3] and seek injunctions against future violations,[4] it can now seek "disgorgement" of the entire gross profit earned by an insider trading scheme against any one defendant regardless of the pecuniary benefit obtained by that particular defendant.[5]

This decision, if left standing, will have significant consequences for individuals in settlement negotiations with the SEC and in any subsequent enforcement action brought by the agency. It would allow the SEC to seek disgorgement awards greatly exceeding any unjust enrichment obtained by the defendant and to seek pre-judgment interest on that whole amount. Indeed, in *Contorinis*, the Second Circuit affirmed an award of nearly $2.5 million in pre-judgment interest on top of the award of $7 million in disgorgement. This article critiques the Second Circuit's opinion and questions whether the SEC, in the exercise of its considerable discretion, should seek disgorgement and pre-judgment interest beyond the benefit a particular defendant obtained from the illegal scheme.

Second Circuit Decision

The underlying facts of the case are straightforward. Defendant Joseph Contorinis made trades on behalf of an investment fund using material nonpublic information he obtained from an employee at an investment bank. Based on those trades, the fund realized profits of $7.3 million and avoided losses of $5.3 million. Contorinis was the co-manager of the fund and had the power to execute trades on its behalf. But he did not control the fund's profits, and the fund did not act in concert with any of the participants in the scheme.[6]

In a split decision, both the majority, consisting of Judges Gerard Lynch and Susan Carney, and the dissent of Judge Denny Chin fully agree on the purposes served and not served by disgorgement. As the majority observed, "[d]isgorgement is an equitable remedy, imposed to force a defendant to give up the amount by which he was unjustly enriched."[7] Further, the majority acknowledges that "disgorgement does not serve a punitive function" and that it "need not serve to compensate the victims of the wrongdoing."[8]

But the majority's analysis appears to force a defendant to "give up" more than he or she obtained and speaks in punitive terms to justify its holding. Comparing a situation in which a defendant obtains personal benefits from insider trading with the situation of defendant Contorinis, the majority writes:

> In the former case, the insider would unquestionably be liable to disgorge the profit; disgorgement is required whether the insider trader has put his profits into a bank account, dissipated them on transient pleasures, or given them away to others. It would likewise make little sense to allow the insider to escape disgorgement when he gives away not the proceeds of a trade predicated on his insider knowledge, but rather the knowledge itself to others who he knows will spin the information into gold by trading on it themselves.[9]

While the two situations may be morally equivalent, as the majority implies, this comparison begs the legal question of whether disgorgement may extend beyond the amount of personal gain obtained by a particular defendant.

In further justification of its decision, the majority relies upon concepts of fault and compensation: "There is no injustice…in making him responsible for the profits he made for others, as well as for himself, through his fraudulent insider trades."[10] The majority opinion concludes: "Our conclusion prevents insider traders from evading liability by operating through or on behalf of third parties." But notions of making defendant "responsible" for the profits of the scheme and of not allowing him to "evad[e] liability" seem to be more consistent with making him pay damages for his role in the scheme as opposed to making him disgorge ill-gotten gains.

The Second Circuit's reliance on *SEC v. Warde*[11] appears to be misplaced. There, the circuit upheld the disgorgement of profits from insider trading that had accrued to a family trust to which the defendant was the sole present beneficiary and an account in his wife's name over which he exercised complete control.[12] In dicta, *Warde* theorized that, even if the insider trading profits had been realized by a third party, the defendant would still have been liable to disgorge the sum of those profits.[13] But as Judge Chin observes in his dissent, while "[a] tipper can be responsible for the tippee's profits because both joint actors

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are deemed to be in possession or control of their concerted activity," the fund in this case "did not act in concert with Contorinis in his criminal venture, and he never possessed or controlled its profits."[14]

The Second Circuit's reliance on two of its previous decisions, *Elkind v. Ligget & Myers*[15] and *SEC v. Texas Gulf Sulphur*,[16] is likewise misplaced because neither decision addresses the proper contours of disgorgement. Rather, *Elkind* dealt with the calculation of compensatory damages in a private class action lawsuit,[17] and *Texas Gulf Sulphur* involved common-law civil restitution.[18] While the Second Circuit states that its reasoning in *Contorinis* had "deep roots in parallel civil remedial structures[,]"[19] we do not believe that the two cited cases support that assertion.

While the majority observes that district courts enjoy discretion when imposing disgorgement on a particular defendant for gains accruing to innocent third parties, this discretion does not remove the anomalous results ushered in by the Contorinis decision. First, the SEC could seek "disgorgement" of all the profits from one defendant to the exclusion of other tippees and to the exclusion of relief defendants.[20] Indeed, should defendant Contorinis pay the full amount of the disgorgement and pre-judgment interest, the SEC would be barred from seeking additional money from the original tipper in the case, as a culpable participant, or from the fund enjoying the gains from the insider trading scheme, as a relief defendant.[21] The majority's only response to this anomalous outcome is to note that "third party recipients [of illegal profits], though unjustly enriched, may have been unaware of any wrongdoing."[22]

Second, *Contorinis* permits district courts to disgorge large sums from defendants which dwarf the civil penalties that are designed to punish defendants for the illegal scheme. Indeed, the district court ordered "disgorgement" of over $7 million from Mr. Contorinis in ill-gotten gains that he never obtained while only imposing $1 million in civil penalties. While the SEC is authorized under the Exchange Act to seek "any equitable relief that may be appropriate or necessary for the benefit of investors,"[23] this result does not seem to reflect a coherent approach in seeking monetary sanctions.

Considerations

The majority's decision in *Contorinis* may not be the last word. First, Contorinis has filed a petition for panel rehearing or rehearing en banc. Second, a petition for a writ of certiorari may be filed in the future requesting that the Supreme Court resolve divergent approaches to disgorgement that have taken hold in different circuits. As the majority in *Contorinis* observes, the U.S. Court of Appeals for the Fifth Circuit in *SEC v. Blatt*[24] bars the disgorgement of profits which the defendant never possessed.[25]

> The Second Circuit affirmed the district court's imposition of an order that the defendant must disgorge over $7 million in profits from an insider trading scheme that only benefited the fund he managed.

But practitioners need to deal with *Contorinis* now. This new tool gives the SEC flexibility and more leverage in negotiating settlements in certain enforcement actions. In situations where the defendant makes large trades on behalf of an investment fund, he could potentially be on the hook to disgorge millions of dollars even though he never possessed or personally controlled any of the profits from that trading. In addition, because disgorgement is an equitable remedy, it is ordinarily exempted from the five-year statute of limitations applicable to civil penalties set forth in 28 U.S.C. §2462.[26] As a result, the SEC's ability to pursue older insider trading cases is enhanced.

The larger question that remains is whether the SEC should pursue disgorgement for the full amount of the illegal profits in the Second Circuit in the event that *Contorinis* stands. A number of policy questions can be raised in the wake of *Contorinis*. First, if the SEC focuses on collecting disgorgement from enforcement defendants—as opposed to collecting it from the third party as a relief defendant—this approach may not be fruitful. Past studies suggest that the SEC's collection efforts have not been successful in many cases.[27] Second, it would seem an odd result for certain tippees or relief defendants to keep what the SEC views as illegal profits when the one prosecuted defendant has paid the full amount (or possibly is simply found to be liable to pay the full amount). Third, it would seem that a uniform policy throughout the country should be the objective of law enforcement, such that the SEC should not seek a disgorgement amount in the Second Circuit which is questioned or barred in two other circuits.

1. *SEC v. Contorinis*, 12-1723-cv, 2014 WL 593484, at *5 (2d. Cir. Feb. 18, 2014).
2. In insider trading cases, the SEC may seek a civil penalty of up to three times the profit gained or the loss avoided. 15 U.S.C. §78u-1(a)(2).
3. 15 U.S.C. §78u(d)(2).
4. 15 U.S.C. §78u(d)(1).
5. Defendant Contorinis was also found guilty in a parallel criminal case and ordered to serve six years in prison and to forfeit $427,875 in inflated compensation linked to the insider trading. See *SEC v. Contorinis*, 2014 WL 593484, at *1-2. In affirming the conviction, the Second Circuit held that the district court's original forfeiture calculation of $12 million was in error because it required Contorinis "to forfeit funds that were never possessed or controlled by himself or others acting in concert with him." *United States v. Contorinis*, 692 F.3d 136, 148 (2d Cir. 2012).
6. *SEC v. Contorinis*, 2014 WL 593484.
7. Id. at *2 (internal quotations omitted); see also id. at *9.
8. Id. at *2; see also id. at *10 (stating that disgorgement is not intended to be punitive).
9. Id. at *4; but see id. at *11 (stating that there was no tipper-tippee relationship that would justify the district court's disgorgement order because there was no joint activity between Contorinis and the fund).
10. Id. at *5.
11. *SEC v. Warde*, 151 F.3d 42 (2d Cir. 1998).
12. Id. at 49.
13. Id.
14. *SEC v. Contorinis*, 2014 WL 593484, at *11.
15. *Elkind v. Ligget & Myers*, 635 F.2d 156 (2d Cir. 1980).
16. *SEC v. Texas Gulf Sulphur*, 446 F.2d 1301 (2d Cir. 1971).
17. See *Elkind*, 635 F.2d at 172.
18. See *Texas Gulf Sulphur*, 446 F.2d at 1307-08.
19. *SEC v. Contorinis*, 2014 WL 593484, at *3.
20. Both the majority and dissent observe that the SEC could have sought disgorgement of the insider trading profits from the fund as a relief defendant but instead chose to seek it from Contorinis. Id. at *5 n.4, *12 n.1.
21. See *SEC v. AbsoluteFuture.com*, 393 F.3d 94, 97 (2d Cir. 2004) (holding that "when the profits of multiple defendants are to be disgorged, the total disgorgement amount cannot exceed the combined profits of the defendants").
22. *SEC v. Contorinis*, 2014 WL 593484, at *5 n.4.
23. 15 U.S.C. §78u(d)(5).
24. *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978).
25. *SEC v. Contorinis*, 2014 WL 593484, at *6 n.5. The U.S. Court of Appeals for the Ninth Circuit has followed a similar approach, limiting disgorgement to an amount "approximately equal to the unjust enrichment" of a defendant where the original award "amounted to more than ten times the amount of the unjust enrichment." *Hateley v. SEC*, 8 F.3d 653, 656 (9th Cir. 1993) (reducing a disgorgement order from $55,000 to the $5,000 where a co-defendant was separately ordered to disgorge $50,000 of his profits); Cf. *SEC v. First Pac. Bancorp*, 142 F.3d 1186, 1192 (9th Cir. 1998) (finding an individual liable for the disgorgement of profits obtained by corporate co-defendants because the violation was a coordinated enterprise from which he enjoyed a substantial personal benefit).
26. See, e.g., *SEC v. Kelly*, 663 F.Supp.2d 276, 286 (S.D.N.Y. 2009) (collecting cases holding that equitable remedies are exempted from the five-year limitations period set forth in 28 U.S.C. §2462). The Supreme Court's decision last year addressing the five-year statute of limitations for civil penalties did not reach the issue of whether the statute applied to injunctive relief. See *SEC v. Gabelli*, 133 S.Ct. 1216, 1220 n.1 (2013).
27. See Government Accountability Office, SEC and CFTC Penalties: Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed, at 24, GAO-05-670, (Washington, D.C.: August 2005), available at http://www.gao.gov/assets/250/247566.pdf (stating that the SEC collected only 34 percent of the $3.3 billion in disgorgement levied in 2004).