

## Disgorgement In The Second Circuit: Equitable Relief Or Punishment?

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In legal circles, disgorgement is known as an equitable remedy used to force a defendant to return money or property earned from illegal conduct. Traditionally, disgorgement has not been used as punishment, but a recent Second Circuit decision has suggested that disgorgement may now be a punitive remedy in disguise. In September 2005, Joseph Contorinis, an investment banker at Jefferies & Company, was given confidential information from a friend and fellow investment banker regarding a major financial acquisition. Contorinis used the non-public information to make very profitable trades for a Jefferies' fund that Contorinis managed and controlled. By virtue of the information Contorinis had received and his subsequent trades, the fund earned a profit of \$7,304,738, and avoided a loss of \$5,345,700. Most importantly, Contorinis did not personally profit from the trade, with exception to \$427,875 he received as compensation linked to the trades on behalf of his employer, Jefferies & Company. In February 2009, Contorinis was convicted of conspiracy to commit securities fraud and seven counts of securities fraud in the U.S. District Court for the Southern District of New York. He was ordered to pay \$12,650,438, which equaled the profit realized by the fund plus the avoided losses. Contorinis appealed his conviction and the forfeiture penalty. The Court of Appeals for the Second Circuit upheld his conviction, but overturned the forfeiture order on the grounds that the language of the criminal forfeiture statute did not support the proposition that a criminal defendant must forfeit profits received by an "innocent third party" that were "never possessed by the defendant."<sup>[1]</sup> In the corresponding SEC civil proceeding, Contorinis was not so lucky. In *SEC v. Contorinis*,<sup>[2]</sup> the SEC sought to disgorge \$7,260,604 from Contorinis. The District Court ultimately ordered Contorinis to disgorge the fund's profits, plus another \$2,485,205 in prejudgment interest—a total of nearly \$10 million. Keep in mind, Contorinis only personally earned \$427,875 from the illegal trades. Not surprisingly, Contorinis appealed, arguing that since he did not trade for his own account with his own funds, but instead on behalf of the fund whose assets belonged to third-party investors, he should not be responsible for paying back all of the fund's profits earned from his illegal trades. In a 2-1 vote, the Second Circuit disagreed, relying on its long-standing "tipper-tippee" principle that attributes the gains of the recipient of non-public information (i.e. the "tippee") to the informant (the "tipper"). In other words, the informant is required to disgorge all profits realized by the recipient of the non-public information, regardless of whether or not the informant himself realized any benefit. The Court opined, "...it must follow that the insider who, rather than passing the tip along to another, directly trades for that other's account must equally disgorge the benefit he obtains

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for his favored beneficiary...We thus conclude that the district courts possess discretion to allocate disgorgement liability for insider trading to those responsible for the illegal acts, including to those with investment power over third-party accounts used to make illegal investments as well as to tippers.” The Second Circuit’s decision dramatically expands the SEC’s power to levy fines and force defendants to the negotiating table. Hedge fund managers and institutional investors should be keenly aware of the extent of the potential personal civil liability they may be exposed to if and when their third-party beneficiaries profit handsomely. Of equal import is that the decision leads one to speculate whether disgorgement in insider trading cases may have a punitive slant. By definition, disgorgement is an equitable remedy which, in theory, should disgorge from the defendant the amount of his gain. As noted by Judge Denny Chin, the sole dissenter, “[d]isgorgement thus should have the effect of returning a defendant to his status quo prior to the wrongdoings...Instead of returning Contorinis to his status quo prior to his wrongdoings, the district court’s disgorgement order penalized him by requiring him to pay an amount equal to the \$7.2 million in profits earned by the fund and an additional \$2.5 million in prejudgment interest.” Judge Chin makes a compelling point. Contorinis is required to “disgorge” almost 23 times the amount he profited from his insider trading. Clearly, such a disproportional penalty couched as equitable relief can reasonably be viewed as punitive in nature and therefore inappropriate in the context of equity. In fact, it may raise substantive due process implications since the Supreme Court’s *Haslip* case in 1991 that ruled the Constitution imposes substantive limits on the size of punitive damages awards. In *Haslip*, the Court said that, when the ratio of punitive to compensatory damages exceeds 4:1, such a punitive damages award is constitutionally suspect.<sup>[3]</sup> And since the Court said later in the *Campbell* case that few awards where that ratio exceeds single digits will satisfy due process, Contorinis, or the next defendant in his shoes, might be able to assert that the Constitution prohibits such a punishment dressed up as “equitable” relief.<sup>[4]</sup>

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[1] *United States v. Contorinis*, 692 F.3d 136, 147 (2<sup>nd</sup> Cir. 2012).

[2] *Securities and Exchange Commission v. Contorinis*, 743 F.3d 296 (2<sup>nd</sup> Cir. 2014).

[3] *Pacific Mutual Life Insurance Co. v. Haslip*, 499 U.S. 1 (1991).

[4] *State Farm v. Campbell*, 538 U.S. 408 (2003).