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Second Circuit Maintains Expansive View of Civil Liability for Insider Trading

By Joel C. Haims and Kayvan B. Sadeghi[1]

On February 18, 2014, in *SEC v. Contorinis*,[2] the Court of Appeals for the Second Circuit affirmed an order requiring Joseph Contorinis to personally disgorge more than $7 million in insider trading profits realized by a fund he co-managed, even though he did not personally receive those profits. In doing so, the court continued its expansive reading of civil liability for insider trading.

The Second Circuit's broad view of civil disgorgement follows an earlier opinion in which the court adopted a similarly expansive view of what is required to establish civil liability for insider trading. In 2012, in *SEC v. Obus*,[3] the Second Circuit held that actual knowledge of a breach of a duty was not required to establish civil liability for either a tipper or a tippee. Rather, a tipper's liability could flow from recklessly disregarding the nature of the confidential or nonpublic information, and a tippee's liability could arise if he had "reason to know"[4] that the information may have been disclosed in violation of a duty of confidentiality.

Contorinis will facilitate the SEC's pursuit of large civil recoveries beyond the tippee's personal benefit from any insider trading.

BACKGROUND

Joseph Contorinis was a Managing Director at Jeffries & Company, Inc. ("Jeffries") who executed several trades involving the stock of the supermarket chain Albertson's, Inc. ahead of its 2006 buyout.[5] In 2010, Contorinis was convicted of making several trades based on tips from a former banker at UBS AG who was privy to confidential information concerning the buyout.[6] These trades were made not for Contorinis' personal account, but only on behalf of the Jeffries Paragon Fund that he co-managed.[7] The court, in his criminal case, found Contorinis' "personal profit" to be $427,875 of "linked compensation from the trades" and ordered forfeiture of that amount.[8]

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[1] Joel Haims is a partner in the litigation department of Morrison & Foerster's New York office and co-chairman of the firm's Securities Litigation, Enforcement, and White Collar Defense Group. Kayvan Sadeghi is Of Counsel in the litigation department of Morrison & Foerster's New York office and a member of the firm's Securities Litigation, Enforcement, and White Collar Defense Group.

[2] Slip Op., No. 12-1723-cv (Feb. 18, 2014).

[3] 693 F.3d 276 (2d Cir. 2012). In *Obus*, the SEC alleged that a tipper revealed information to his friend who worked for a hedge fund, who in turn relayed that information to his boss, who traded based on the information.

[4] *Obus*, 693 F.3d at 289.

[5] *Contorinis*, Slip Op. at 4.

[6] *Id.* at 4-5.

[7] *Id.* at 5.

[8] *Id.* at 6.

Yesterday's Second Circuit opinion arose out of a subsequent civil case brought by the SEC seeking disgorgement from Contorinis of the profits obtained by the Paragon Fund.[9] The district court granted summary judgment for the SEC and ordered disgorgement of $7,260,604, reflecting the fund's profits, prejudgment interest of $2,485,205 on the entire disgorgement amount, and a civil penalty of $1 million.[10] Contorinis appealed the judgment insofar as it required him to disgorge the amount obtained by the Paragon Fund and related prejudgment interest, arguing that it was a misapplication of the principle of disgorgement.[11]

"The question is thus posed whether an insider trader can be required to disgorge not only the profit that he personally enjoyed from his exploitation of inside information, but also the profits of such exploitation that he channeled to friends, family, or clients."[12]

THE COURT'S DECISION

The court began its analysis by noting that it had "long applied" the principle of disgorgement in the tipper-tippee context to require disgorgement of "the benefit that accrues to third parties whose gains can be attributed to the wrongdoer's conduct."[13] The court explained that this must be so because a tipper could achieve the same result by either trading on inside information and passing on the profit to a third party, trading directly for their account, or by passing the information to the third party "who he knows will spin the information into gold by trading on it themselves."[14] In each instance, the wrong committed and the economic result would be the same.

"Whether the defendant's motive is direct economic profit, self-aggrandizement, psychic satisfaction from benefiting a loved one, or future profits by enhancing one's reputation as a successful fund manager, the insider trader who trades for another's account has engaged in a fraud, secured a benefit thereby, and directed the profits of the fraud where he has chosen them to go."[15]

The court opined that the case for disgorgement under the facts before it, of a tippee trading for the benefit of others, was even stronger than the case for disgorgement against a tipper. A tipper may not know the extent to which the tippee will trade, and thus would have no idea of the potential exposure to disgorgement. In contrast, Contorinis "controlled the size and timing of the trades" and received financial and other reputational benefits from the trades.[16]

Notably, the court made clear that disgorgement of gains that accrue to innocent third parties was not mandatory, but rather within the discretion of the district court.[17] The court remarked on disgorgement's remedial purpose—"disgorgement is imposed not to punish, but to ensure illegal actions do not yield unwarranted enrichment"—and

[9] *Id.* at 6.

[10] *Id.* at 7.

[11] *Id.* at 7, 9.

[12] *Id.* at 10.

[13] *Id.* at 10-11 (citing *SEC v. Warde*, 151 F.3d 42, 49 (2d Cir. 1998).

[14] *Id.* at 12-13.

[15] *Id.* at 13.

[16] *Id.* at 14.

[17] *Id.* at 16.

held that "[d]istrict courts possess the equitable discretion to determine whether disgorgement liability should fall upon third parties or violators. . . ."[18]

Contorinis argued that ordering him to disgorge the Paragon Fund's profits in the SEC's civil case would be inconsistent with the holding in his criminal case, in which criminal forfeiture was limited to his personal gain.[19]

The majority disagreed based on the different purposes of criminal forfeiture and civil disgorgement: "disgorgement is an equitable remedy that prevents unjust enrichment, and criminal forfeiture a statutory legal penalty imposed as punishment."[20] The court also noted that criminal forfeiture is mandatory and imposed by statute, whereas disgorgement is an equitable remedy within the court's discretion. [21] The court found that failure to order civil disgorgement for defendants such as Contorinis "would allow them to unjustly enrich their affiliates," and thus the district court's order here "serves disgorgement's core remedial function."[22]

CONCLUSION

Contorinis is the most recent reflection of the Second Circuit's broad view of civil liability for insider trading. As such, it may embolden the SEC's pursuit of insider trading cases and of civil recoveries beyond the reach of criminal forfeiture of personal profits, and extending to any profits channeled to others.

Contact:

Joel C. Haims
(212) 468-8238
jhaims@mofo.com

Kayvan B. Sadeghi
(212) 336-4149
ksadeghi@mofo.com

[18] *Id.* at 22-23.

[19] *Id.* at 21.

[20] *Id.*

[21] *See id.* at 23. In dissent, Judge Chin noted that disgorgement is intended to return the defendant to the "status quo prior to the wrongdoing" and that the order here went beyond that by requirement Contorinis "to disgorge funds he never had and to pay back profits he never received." *Id.*, Chin, J. dissenting, at 2.

[22] *Id.* at 22-23.