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Judicial Authority to Order Disgorgement in SEC Action Upheld

The Second Circuit Court of Appeals further narrowed the scope of the Section 4(l) registration exemption under the Securities Act of 1933,[1] and validated the federal courts' equitable authority to impose disgorgement as a remedy in a securities fraud action brought by the Securities and Exchange Commission ("SEC") in its recent holding in *SEC v. Cavanagh*.[2] In holding that the defendants were not entitled to a Section 4(l) exemption, the *Cavanagh* Court considered the "defendants' role in the orchestration and negotiation" of a series of transactions, rather than the defendants' status at the moment of any single transaction.[3] Next, the Court addressed the question of whether the doctrine of disgorgement had survived the Supreme Court's decision in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*,[4] which limited the courts' equitable powers. The Court of Appeals held explicitly that the equitable power to order disgorgement had been vested in the federal courts by the Constitution and the Judiciary Act.

Facts and History

The case arose from a series of fraudulent transactions by a group of persons led by Thomas Cavanagh and Frank Nicolais,[5] who operated an investment banking company called U.S. Mile-

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1 15 U.S.C. § 77d(1) (the "1933 Act"). Section 4(l) exempts certain transactions involving the sale of securities from the registration requirements of Section 5 of the 1933 Act by persons other than issuer, underwriter or dealer. Under Section 5, a person may not directly or indirectly sell or transfer securities using means of interstate commerce, unless a registration statement is in effect. *Id.* §77e. An "affiliate" of an underwriter, issuer or dealer is treated as an issuer under the 1933 Act and, therefore, must register shares before attempting to sell them.

2 *SEC v. Cavanagh*, 04-54020CV(L), 2006 WL 905911 (2d Cir. Apr. 10, 2006). Defendants in this case appealed a summary judgment order entered by the district court in favor of the SEC. *See SEC v. Cavanagh*, 2004 WL 1594818 (S.D.N.Y. July 16, 2004) ("*Cavanagh I*").

3 *Cavanagh*, 2006 WL 905911, at *7.

4 527 U.S. 308 (1999).

5 The named defendants included certain other USM affiliates as well as Curbstone defendants. For purposes of this memorandum, further elaboration distinguishing various groups of defendants is not neces-

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stone ("USM"). In 1997, USM agreed to finance a company called WTS Transactional, Inc. ("WTS"), a fledgling security technology company, through a public shell corporation, Curbstone Acquisition Corp. ("Curbstone").[6] USM arranged an initial transaction whereby Curbstone would acquire WTS, and WTS's management would replace Curbstone's. The effect of the transaction was a "reverse acquisition."[7] The reverse acquisition was produced through a Stock Exchange Agreement ("Agreement"), under which WTS shareholders exchanged all of the outstanding shares of WTS for newly issued shares of the surviving entity, Electrono-Optical Systems Corporation ("EOSC").[8] Importantly, many of the new EOSC shares were subject to a lock-up agreement, preventing the transfer of the shares until March 15, 1998, about 3 months after the companies entered into the Agreement.[9]

USM then used foreign purchasers to control the supply of EOSC stock to the market, which artificially inflated the stock price. Meanwhile, certain of WTS's directors began selling EOSC stock as soon as the reverse merger had occurred. Cavanagh and Nicolais accomplished the overvaluation of EOSC stock by issuing false and misleading press releases, purchasing small amounts of the stock at inflated prices, and managing the supply of the shares on the market.[10] After the SEC opened an investigation into the trading of EOSC stock, the share price fell dramatically and caused the innocent shareholders approximately $15 million in losses. The SEC filed the civil enforcement action in the Southern District of New York on March 13, 1998, alleging violations of the registration and antifraud provisions of the securities laws.[11]

The district court held that USM violated sections 5 and 7 of the 1933 Act and section 10(b) of the Securities and Exchange Act of 1934 (the "1934 Act"). As damages, the lower court imposed $1 million in penalties on defendants Cavanagh, Nicolais and USM, and further ordered that each of them disgorge to the court all profits resulting from the scheme, with interest.[12] On appeal, defendants

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sary.

6 Curbstone had no assets at the time, but approximately 3,500,000 shares registered with the SEC.

7 The term "reverse acquisition" refers to a transaction in which an acquiring company merges with and into the company acquired. Using this technique, a private company may acquire a public company and so "go public" without undergoing an underwritten initial public offering of its shares and having to satisfy the 1933 Act registration and disclosure requirements such an offering entails. *See Cavanagh*, 2006 WL 905911, at n.4.

8 *Id.*, 2006 WL 905911, at *1-2.

9 Both the district court and the Court of Appeals highlighted the fact that without the ability to restrict the transfer of the new Curbstone shares, the fraud would not have been possible. *See Cavanagh*, 2006 WL 905911, at n.6; *Cavanagh I*, 2004 1594818, at *5.

10 *Cavanagh*, 2006 WL 905911, at *2.

11 *Id.*

12 *Id.* at *3.

challenged the finding that they were subject to the registration requirements of the 1933 Act and the court's power to impose the disgorgement remedy.

Registration Requirements

First, the Court of Appeals addressed the question of whether the district court appropriately applied the "integration doctrine" to prevent the defendants from avoiding liability under section 5 of the 1933 Act.[13] The district court had concluded that the series of transactions surrounding the reverse acquisition "were part of the integrated transaction and cannot be excised from it."[14] Although the Court of Appeals affirmed the district court's conclusion that the defendants were "affiliates" and, therefore, subject to the 1933 Act registration requirements, the Court relied instead on the more exacting standard of the Rule 144[15] to preclude exemption for the defendants. Given the strong public policy impetus in favor of registered offerings, the Court found that the defendants did not satisfy for an exemption from 1933 Act registration outside of the Rule 144 safe harbor.[16] In fact, the Court regarded the series of events as part of one larger transaction, in which the defendants were clearly "affiliates":

> "In these circumstances, a person who is an 'affiliate' during the negotiation of, and agreement to, the deal may not enjoy a Section 4(l) exemption by simply abdicating his affiliate status (e.g., by selling his controlling shares or resigning as an officer or director) shortly before the parties complete the transaction. Here, defendants' role in orchestrating the transaction while they were affiliates precludes them from enjoying Section 4(l) exemptions regardless of whether they left Curbstone before the unregistered sales occurred."[17]

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[13] Under the "integration doctrine," the SEC analyzes "whether (1) different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose." Non-Public Offering Exemption, 1933 Act Release No. 33-4552, 27 Fed. Reg. 11,316 (Nov. 16, 1962).

[14] *Cavanagh I*, 2004 WL 1594818 at *21.

[15] 17 C.F.R. § 230.144(k). Whereas Section 4(l) of the 1933 Act exempts from registration the sale of securities by persons who are not affiliates of the issuer at the time of sale, Rule 144(k) requires that a person not be an affiliate of the issuer for an additional three months prior to the date of an unregistered sale.

[16] *Cavanagh*, at *5-7 ("Registration exemptions are construed strictly to promote full disclosure of information for the protection of the investing public. It would defeat the purpose of the broad definition of an 'issuer'—which includes 'affiliates' because affiliates are treated as issuers under Section 4(l)—and frustrate the broad remedial goals of the securities laws, to permit affiliates, with full access to non-public information, to negotiate terms of a sale but then escape liability simply by terminating their affiliate status immediately prior to consummating the transaction.").

[17] *Id.* at 14 (citing *SEC v. Kern*, 425 F.3d 143, 153 (2d Cir. 2005), and *Geiger v. SEC*, 363 F.3d 481, 487 (D.C. Cir. 2004)).

The Court's reasoning was based on the fact that the success of the transactions was dependent on the control over the EOSC stock that the defendants possessed as a result of their initial status as affiliates.[18] Thus, the Court limited the scope of the section 4(l) exemption to adhere closely to the requirements of Rule 144.

Disgorgement

Second, the *Cavanagh* Court reviewed the viability of the equitable remedy of disgorgement in light of the Supreme Court's recent holding in *Grupo Mexicano de Desarollo, S.A. v. Alliance Bond Fund, Inc.* One defendant appealed that the remedy was outside of the Court's equitable powers. The remedy of disgorgement is purely remedial and acts to compensate victims for their losses. The remedy is within the discretion of the court and does not have a punitive aspect. That is, the court cannot assess penalties beyond the financial windfall of the defendant.[19] The purpose of disgorgement is to prevent unjust enrichment of ill-gotten profits. However, as the *Cavanagh* Court points out, "The primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing the defendant to give up the amount by which he was unjustly enriched."[20] Effectively, the remedy removes any incentive to defraud investors.[21]

The Constitution[22] and the Judiciary Act,[23] the Court argued, gave contemporary federal courts the same equitable powers as the chancery courts had during the eighteenth century. The Court relied on the Supreme Court's holding in *Grupo Mexicano* that the federal courts possess "an authority to administer in equity suits the principles of the system of judicial remedies which had been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries."[24] Thus, the question for the *Cavanagh* Court was "whether the remedies available at chancery in 1789 included disgorgement."[25]

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18 *Id.* at 16.

19 *Id.* at 17 (citing *SEC v. Tex. Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971) ("Restitution of profits on these transactions merely deprives the appellants of the gains of their wrongful conduct. Nor does restitution impose a hardship in this case.").

20 *Id.* at 17-18 (quoting *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) (Friendly, J.) (internal quotation marks omitted).

21 Outside of criminal penalties, civil plaintiffs must succeed in an action against a fraudulent insider to recover any loses. However, disgorgement provides a mechanism whereby the SEC can ensure that the defendant does not profit from the fraud.

22 U.S. CONST. art. III, § 1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.").

23 1 Stat. 73, 78 (1789) (giving federal courts jurisdiction over "all suits ... in equity").

24 *Grupo Mexicano*, 527 U.S. at 318; *see Cavanagh* at 18.

25 *Cavanagh* at 19.

The *Cavanagh* Court proceeded with an examination of the history of equitable relief in the American federal court system. The *Cavanagh* Court identified the irrelevant distinction between disgorgement and restitution, pointing out the practical result of remitting any profits to which a defendant can make no legitimate claim.[26] The Court appeared less concerned with the categorical reference to the remedy, focusing instead on the "specific actions and the resulting practical consequences" of applying the equitable remedy.[27] The Court continued to cite a number of English authorities to support the proposition that because the English courts of equity held the power to impose disgorgement, the American federal courts held the same equity powers due to their dual function in law and equity.[28] The disgorgement remedy had its roots in English courts of equity, and, therefore, the *Cavanagh* Court held that the federal courts are vested with the power to order equitable disgorgement.

Conclusion

The *Cavanagh* decision limited the distinction between the Rule 144 safe harbor and the Section 4(l) exemption for the registration requirements under the Securities Act. The holding may result in increased scrutiny of affiliate transactions. The Court further solidified federal jurisdiction over questions of equity by imposing disgorgement as a remedy for securities fraud. The SEC will likely pursue disgorgement as a civil remedy and further enforcement efforts in this context are likely.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles Gilman at (212) 701-3403 or cgilman@cahill.com; Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com; or John Rudy at (212) 701-3930 or jrudy@cahill.com;.

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26 The Court dismissed the difference between the terms that eighteenth century courts used to refer to the act of compelling a party to turn over any profits to which the party can assert no just claim. In an action based in contract, restitution is a quasi-contract remedy that combines equity and law to prevent any unjust enrichment. In that context, the party must return any compensation received beyond the fair value of the amount of performance under the contract. Disgorgement differs in that the culpable party remits any ill-gotten profits to the court, rather than the injured party. *See Cavanagh* at 17. The court may then direct the profits to the victims or to the United States Treasury. *SEC v. Fischbach Corp.*, 133 F.3d 170, 175-76 (2d Cir. 1997) (identifying the SEC's policy "wherever possible ... to recommend a distribution plan by which a defendant's unlawful gains are paid out to defrauded investors") (internal quotation marks omitted).

27 *Id.*

28 *See Cavanagh* at 20-23. The Court also relied on the earlier holding in *United States ex rel. Taylor v. Gabelli*, 2005 WL 2978921, at *5 (S.D.N.Y. Nov. 4, 2005), that disgorgement was a "classic" mechanism to prevent unjust enrichment.