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New York Supreme Court Limits New York Attorney General's Ability to Seek Disgorgement in an Action Brought Under the Martin Act

On December 12, 2012, the New York State Supreme Court issued a decision from the bench in *People ex rel. Schneiderman v. Ernst & Young LLP*, Index No. 451456/10, dismissing the New York Attorney General's ("NYAG") disgorgement claims against Ernst & Young ("E&Y"). The Court held that to sustain a disgorgement claim in the context of a securities fraud action brought under the Martin Act, the NYAG must allege that the defendant obtained the contested funds from either the defrauded investors or the State of New York. Accordingly, where the complaint alleges only that the defendant benefitted from the alleged fraud by receiving payment from a source other than investors or the State, such as the primary wrongdoer, the disgorgement remedy is unavailable. If upheld on appeal, the decision will greatly limit the NYAG's ability to seek disgorgement in securities fraud cases where the defendant is not alleged to have obtained funds directly from investors.

I. Background

On December 21, 2010, the NYAG brought an action against E&Y asserting securities fraud claims under the Martin Act and New York Executive Law § 63(12) in connection with E&Y's role as the outside auditor of Lehman Brothers Holding Inc. ("Lehman Brothers"). The complaint, the first brought by the NYAG against an independent auditor alleging violations of the Martin Act, alleged that E&Y's conduct as Lehman Brothers's outside auditor, including E&Y's issuing unqualified opinion letters and certification of Lehman Brothers's financial statements while being aware of Lehman Brothers's use of "Repo 105" transactions,[1] constituted fraud under the Martin Act and Executive Law. In the complaint, the NYAG sought injunctive relief, monetary damages and restitution, and the disgorgement of some $150 million in fees paid to E&Y by Lehman Brothers from 2001 until Lehman Brothers's bankruptcy in September 2008.

[1] As explained to the court by E&Y, Repo 105 transactions were a form of repurchase agreements in which Lehman exchanged highly liquid assets for cash.

In seeking to dismiss the disgorgement claims, E&Y argued, as a matter of statutory interpretation, that the NYAG lacked authority to seek disgorgement because remedies available under the Martin Act and Executive Law are limited to injunctive relief, restitution and damages. The NYAG countered that disgorgement is an equitable remedy stemming from the court's inherent powers, which is not a punitive measure or a form of restitution, but rather is intended to ensure that a wrongdoer cannot enjoy ill-gotten gains. At oral argument, the NYAG argued that disgorgement was an essential remedy because without it E&Y could settle the class action suit pending against it for less than the value lost in the alleged fraud, thereby continuing to enjoy a portion of its allegedly fraudulently obtained profit. The NYAG further argued that its purpose of seeking to protect the public interest by preserving the integrity of financial markets was served by the disgorgement remedy.

II. The Decision

The Court acknowledged that disgorgement is a remedy that is routinely applied in federal securities actions, but relying on two New York state court cases, *People ex rel. Spitzer v. Applied Card System, Inc*., and *People ex rel. Spitzer v. Direct Revenue LLC*,[2] the Court rejected the NYAG's arguments and dismissed the claim for disgorgement.

In *Applied Card*, the Court of Appeals determined that when a class action is settled it limits the NYAG's ability to pursue restitution claims, although claims for injunctive relief, civil penalties and costs are still viable. Additionally, the *Applied Card* Court noted that it might still be possible for the NYAG to pursue disgorgement after settlement of the class action. In contemplating disgorgement, however, the *Applied Card* Court tied that remedy to profits derived from consumers. In *Direct Revenue*, the Supreme Court dealt with a case in which the NYAG alleged that the defendant's installation of pop-up advertising software was deceptive and illegal under the Truth-in-Lending Act. The *Direct Revenue* Court, in dismissing the case, noted that because the defendant was not alleged to have taken anything of value from consumers (the defendant had been paid by advertising clients) disgorgement would have constituted impermissible punitive damages.

Reading these two cases together, the Court determined that because the NYAG did not allege that E&Y's fees were paid by investors or the State of New York, disgorgement was not an available remedy. The Court stated that the New York statutes do not authorize a remedy of general disgorgement. Disgorged funds must be linked to money fraudulently derived from consumers or the State. During oral argument, the Court noted that if (a) New York State (perhaps through a pension fund's investment) was a defrauded investor, or (b) the NYAG was able to allege that the fees received by E&Y were derived

[2] *People ex rel. Spitzer v. Applied Card Sys., Inc.*, 11 N.Y.3d 105 (2008); *People ex rel. Spitzer v. Direct Revenue LLC*, 19 Misc. 3d 1124(A) (N.Y. Sup. Ct. 2008).

from consumers making investment decisions as the result of E&Y's alleged wrongful conduct, disgorgement may have been an available remedy.

The NYAG has indicated that it will appeal the decision.

III. Implications of the Decision

If the decision is upheld on appeal, the NYAG's ability to seek disgorgement in the securities fraud context is likely to be limited to cases where the defendant directly received funds from investors or the State. As a practical matter, this is likely to limit the NYAG's ability to recover monies in actions against third parties, such as service providers, who did not directly receive funds from the investing public, but are nevertheless alleged to have participated in the fraud. The decision leaves open the question whether the NYAG may avail itself of the disgorgement remedy where either (a) the State is a defrauded investor or (b) the NYAG is able to allege that the fees received by the service provider were derived from investors or consumers making investment decisions as the result of the defendant's wrongful conduct. The NYAG also routinely seeks disgorgement in cases against individuals. It remains to be seen whether New York courts will extend this reasoning to bar the NYAG from seeking to disgorge funds from a wrongdoer's executives, where the executives were paid by the wrongdoer and not by the investors directly.

If you have any questions about this decision, please contact any of your regular contacts at the firm or any of our partners and counsel listed under "Securities Litigation" or "White-Collar Defense, Securities Enforcement and Internal Investigations" in the "Practices" section of our website (http://www.clearygottlieb.com).

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