A Tax Avoidance Approach to Disgorgement Generates a Win for the SEC

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The Securities and Exchange Commission ("SEC") has been awarded a substantial win in its civil enforcement action against Samuel Wyly and Donald R. Miller, Jr. as the Independent Executor of the Will and Estate of Charles J. Wyly Jr. (the "Wylys"). The Court ordered the Wylys to pay a total of $188 million plus pre-judgment interest associated with (i) their use of offshore trusts and subsidiary entities to trade in shares of four public companies they had acquired or founded and on whose boards the Wylys sat (collectively described as the "Issuers" and including Michaels Stores), and (ii) their failure to properly disclose their beneficial ownership of that stock.

In May 2014, the SEC won liability in the bifurcated civil enforcement action. The jury found for the SEC regarding the Wylys's misrepresentations, including those related to the extent of their beneficial ownership of the Issuers in their Director and Officer questionnaires, which were incorporated by the Issuers in proxy statements. The jury also found that the Wylys sold unregistered securities in association with sales of Michaels Stores stock.

The SEC then sought an order of disgorgement in an August bench trial. The SEC's disgorgement calculation included the following components:

1) $194 million in unpaid taxes for gains on the sale of registered Issuer securities, plus $289 million in prejudgment interest, and

2) $65 million in profits made on the sale of unregistered Michaels Stores stock, plus $71 million in prejudgment interest.

In contrast, the Wylys argued that the proper measure should be the economic benefit attributable to the Wylys' failures to 1) cause Michaels Stores to register the securities and 2) file disclosures after the sales. The Wylys put forth an expert who opined as to the adverse impact on the share price that would have occurred with proper disclosures, thereby reducing the Wylys' profit. The Wylys' expert's calculation ranged from $1 – 6 million. However, the Court disagreed that the underlying studies used in the calculations were sufficiently applicable to the underlying facts of the current case or properly took into account the discounted price at which the Wylys purchased the securities.

Disgorgement is an equitable remedy to deprive a defendant of any ill-gotten gains, often called unjust enrichment. It is an economic calculation which captures the incremental profits obtained through wrongful activity and is not intended as a punitive measure. Avoidance of taxes is not usually a measure of damages, but in this case the Court largely accepted the SEC's disgorgement calculation based on unpaid taxes over the Wylys' rebuttal calculation based on the economic impact of the securities violations, writing:

> *"There is no evidence in the record that the purpose of this fraud was to manipulate or distort the market. There is ample evidence, however, that the driving purpose of the*

securities fraud was to conceal the Wylys' relationship to the IOM trusts and preserve the preferential tax treatment on secret offshore profits for as long as possible"

The Court described that in enforcement actions, the SEC does not need to establish that the securities violations were the proximate cause of gains in order to satisfy the "causal connection" requirement. Unlike private plaintiffs, who must demonstrate that the defendants' misstatements or omissions were a proximate cause of their injury at the liability stage, the SEC has no such burden because the purpose of such actions is deterrence, not compensation. As a result, the Court concluded that unjust enrichment can comprise any unlawful gains, even if the amount exceeds actual damages to victims.

Further, the Court found that a measurement based on avoided taxes does not infringe on the IRS' exclusive authority to collect taxes because

> *"This is not a civil action for the collection or recovery of taxes…. Rather, this is a civil action for securities law violations, the remedy for which is measured by the amount of taxes avoided as a result of the defendants' securities violations. Measuring unjust enrichment by approximating avoided taxes does not transform an order of disgorgement into an assessment of tax liability."*

This is an interesting case since, as described by the Wylys, "*no court has ever before approved the use of… any analogous indirect measure of unjust profits*." Given that the Wylys are also under IRS investigation, it may seem that such a finding of unjust enrichment is premature. However, the Court acknowledged that any amounts disgorged in this case should be credited towards any subsequent tax liability determined in an IRS civil proceeding as a matter of equity.

Fulcrum Inquiry performs damages analysis and related expert testimony.