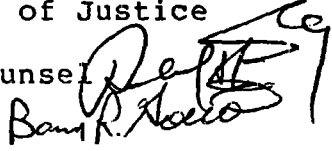


MEMORANDUM

August 6, 1987

TO: D. Patrick Mullarkey, Chief  
Civil Trial Section, Northern Region,  
Tax Division, Department of Justice

FROM: Office of the General Counsel  
Division of Enforcement 

RE: SEC v. Dennis Levine, et al., No. 86 Civ. 3726  
(RO) (S.D.N.Y.): Competing claims of SEC and  
IRS to disgorgement fund.

This memorandum has been prepared by the Commission's staff to provide you with an outline of the legal bases for our claim that a federal court presiding over an SEC injunctive action has the discretion to order that the funds disgorged by Dennis Levine be used to compensate defrauded investors before satisfaction of Levine's tax liabilities. We are providing this memorandum to you as a follow-up to our discussion concerning the possible resolution of issues presented in this case and we understand that you will not disclose its contents to anyone other than your client and persons working with you on this matter.

FACTS

The Commission's civil action against Dennis Levine was brought pursuant to Sections 21(d) and 21(e) of the Securities Exchange Act of 1934, seeking injunctive and other equitable relief (including disgorgement of profits illegally obtained) for violation of Sections 10(b) and 14(e) of the Exchange Act, and Rules 10b-5 and 14e-3 promulgated thereunder. Simultaneously with the filing of its complaint, the Commission sought, and obtained on May 12, 1986, a TRO freezing Levine's assets. The stated purpose of the freeze order was to "prevent irreparable injury to certain public investors and others." The court ordered Levine to hold within his control, and prevent any dissipation of, assets representing the profits derived from his illegal trading activity.

On May 23, 1986, the IRS made a jeopardy assessment and filed a tax lien notice.

Thereafter, on June 5, 1986, the Commission obtained a judgment by consent. The judgment provided that Levine would disgorge approximately \$11.5 million representing the profits from his illegal trading activity. Under the terms of the judgment, the disgorgement was paid to a receiver appointed for that purpose. This \$11.5 million has been transferred to the receivership. The source of these funds was \$10.6 million, obtained from an offshore bank account in which Levine had deposited profits derived from his illegal stock transactions, and the balance from other Levine assets.

Under the decree, claims will be paid pursuant to a plan to be submitted by the Commission and approved by the court. The disgorgement is to be employed for the purpose of satisfying claims arising out of the illegal securities purchases alleged in the complaint. Tax claims are included among the types of claims that may be made against the fund.

#### DISCUSSION

In carrying out its mandate to protect investors, the Commission seeks and obtains orders freezing assets of defendants in order to preserve its claim for disgorgement of profits obtained through fraudulent securities transactions. In keeping with the purposes of disgorgement, the equities favor compensation of defrauded investors out of the disgorged profits prior to satisfaction of any tax claim to those funds. "The victim's right to reimbursement is surely an equity superior to the Government's claim to so much of the tax as is attributable to inclusion in the criminal's income of the amount unlawfully taken, without regard to whether the victim can trace his money or property into the available fund \* \* \* ." Plumb, Federal Liens and Priorities: Agenda for the Next Decade, Part II, 77 Yale L. J. 605, 691 (1968).

In this case, it is well within a court's equitable powers to act to prevent Levine from satisfying his personal tax liabilities at the expense of the investors he defrauded. We set forth below two separate legal theories that would permit a court to accord the defrauded investors a priority with respect to distribution of the disgorgement proceeds obtained by the Commission. First, the court could treat the Commission's freeze order as according the Commission an equitable lien prior in time to the IRS tax lien. Second, irrespective of the priority of the tax lien, a court could impose a constructive trust for the benefit of defrauded investors on the disgorgement proceeds, thereby avoiding the tax lien as to that property.

## I. Equitable Lien

- A. The district court has the power to declare an equitable lien and fix the date of attachment at the time the Commission obtained its TRO.

It is well-established that a court exercising equity power has very broad discretion to fashion a remedy appropriate to the particular circumstances of the case. See, e.g., Porter v. Warner Holding Co., 328 U.S. 395, 398 (1946); Mitchell v. DeMario Jewelry, 361 U.S. 288, 290-91 (1960) (an equity court carrying out the enforcement of federal regulatory prohibition has power to provide complete relief in light of the statutory purposes). See Dent, Ancillary Relief in Federal Securities Law: A Study in Federal Remedies, 67 Minn. L. Rev. 865, 882 (1983) (citing cases).

The Commission's interest is based on its mandate to protect investors and promote the integrity of the securities markets. In a series of cases, most notably the landmark insider trading case SEC v. Texas Gulf Sulphur, 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971), the courts have upheld the Commission's power to seek and the court's power to order disgorgement of the profits obtained from insider trading as ancillary to the court's power to order injunctive relief. The purpose of disgorgement is twofold: to prevent the wrongdoer from retaining the proceeds of his illegal activities and to compensate injured investors. See e.g., SEC v. Manor Nursing Centers, 458 F.2d 1082, 1105 (2d Cir. 1972) (one of the chief reasons for ordering disgorgement is "to compensate defrauded investors"). Farrand, Ancillary Remedies in SEC Civil Enforcement Suits, 89 Harv. L. Rev. 1779, 1803 (1976) (compensatory monetary awards are uniquely suited to promote investor confidence in securities transactions).

Among the equitable remedies available to a court in a Commission enforcement action is the court's equity power to declare an "equitable lien" that arises from the date of the freeze order entered by the TRO. The Commission's TRO should be given the force and effect of a lien, and since it is prior in time to the lien created by the IRS jeopardy assessment the TRO has priority. An equitable lien is a well-established device of effecting remedial relief and it "may be declared by a court of equity out of general considerations of right and justice as applied to the relationship of the parties." Caldwell v. Armstrong, 342 F.2d 485, 490 (10th Cir. 1965); see generally G. Bogert, Trusts and Trustees § 32 (rev. 2d ed. 1984). 1/

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1/ The court hearing the Levine cases has recognized, in refusing to dismiss a claim seeking an equitable lien, that in order to provide remedies for the victims of fraud, its

The history of equitable relief in Commission enforcement actions provides support for a court flexibly employing its equity powers in order to vindicate the Commission's mandate to insure compliance with the securities laws. See, e.g., Chris-Craft Industries v. Piper Aircraft Corp., 480 F.2d 341, 390-391 (2d Cir.), cert. denied, 414 U.S. 910 (1973) (once Commission has properly invoked equity jurisdiction of the district court, the court has power to grant all equitable relief appropriate under the circumstances); SEC v. Wencke, 577 F.2d 619, 623 (9th Cir.), cert. denied, 439 U.S. 964 (1978) ("Wencke I"); SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir. 1980) ("Wencke II"). Courts have created a wide range of equitable devices, such as appointment of receivers, reorganization of management structures, and disgorgement itself. See Farrand, Ancillary Remedies, 89 Harv. L. Rev. at 1779. The creation of an equitable lien here would be consistent with these existing remedial devices. It enables the court to give meaningful effect to one of the purposes for which the Commission obtains disgorgement of illegal profits.

B. The Commission's lien is not subject to the "choateness" doctrine.

The choateness doctrine 2/ as applied to federal tax lien priorities had its origin in a series of Supreme Court cases of the 1950's. See Plumb, Federal Tax Liens at 149-150. The purpose of this doctrine is to prevent states from interfering with the collection of federal taxes. See New Britain, 347 U.S. at 86

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1/ (Continued)

discretion to order relief must be given broad scope. See Lumbard v. Maglia, Inc., 621 F. Supp 1529, 1538 (S.D.N.Y. 1985) ("Although we know of no case granting the precise relief requested, that fact alone cannot rule out a grant of certain equitable relief tailored to the circumstances of the case -- nor can it assure such relief.")

2/ Federal tax liens have priority over "inchoate" non-federal liens (absent certain statutorily created priorities). In order for a lien to be considered choate, the identity of the lienor, the property subject to the lien, and the amount of the lien may not be contingent, but must be fully and finally established. See, e.g., United States v. City of New Britain, 347 U.S. 81, 84-86 (1954).

(in the absence of the choateness requirement, "a State could affect the standing of federal liens \* \* \* simply by causing an inchoate lien to attach at some arbitrary time \* \* \* "). See also United States v. Pioneer Insurance Co., 374 U.S. 584, 589 (1963); Asher v. United States, 436 F. Supp. 22, 25 (N.D. Ill. 1976), aff'd, 570 F.2d 682 (7th Cir. 1978).

The choateness doctrine has no applicability here. In the Levine case, we have two competing claims derived from federal agencies each attempting to carry out its federal statutory mandate. Thus, the district court, in exercising its broad equity powers to effect appropriate relief in this case (see infra p. 3) need not adhere to the choateness requirement designed to assure federal priority over state created interests. See Plumb, Federal Tax Liens at 163 ("[A] determination of the relative standing of two federally created liens \* \* \* frees a court from the need to consider the possible effect of rival rules of priority created by different sovereigns.") (emphasis in original.) Thus, the equitable lien created by the Commission's TRO freezing Levine's assets may be given priority over the later IRS tax lien based on the federal common law "first in time" rule. See United States v. Kimbell Foods, 440 U.S. 715, 720 n.7 (1979).

## II. Constructive Trust

### A. A tax lien cannot attach to property subject to a constructive trust.

It is well-settled that a federal tax lien cannot attach unless the taxpayer has an interest in the property sought to be attached. See, e.g., United States v. Fontana, 528 F. Supp. 137, 146 (S.D.N.Y. 1981) ("the validity of the Government's tax lien depends on whether the [taxpayers] had a sufficient property interest in the fund, which they lack if a constructive trust is found"); Atlas v. United States, 459 F. Supp. 1000, 1005 (D.N.D. 1978) (no federal tax lien could attach to money or property obtained through embezzlement since embezzler held the proceeds as constructive trustee for the victim); Dennis v. United States, 372 F. Supp. 563, 566 (E.D. Va. 1974); Aquilino v. United States, 10 N.Y.2d 271, 176 N.E.2d 826 (1961). Moreover, when money is obtained by fraud, a constructive trust arises at the date of wrongdoing and no tax lien can attach. Fontana, 528 F. Supp. at 146. Since the disgorgement fund represents Levine's illegal profits, the subsequent IRS tax lien cannot attach to any of those funds.

- B. Under New York law, a constructive trust may be declared in favor of defrauded investors who traded contemporaneously with Levine.

In determining whether property exists to which a federal tax lien may attach, a court must look to applicable state law. See, e.g., Aquilino v. United States, 363 U.S. 509, 513 (1960) (in the application of a federal revenue act, state law controls in determining the interest the taxpayer has in the property). New York law <sup>3/</sup> strongly endorses the principle that a court should flexibly employ constructive trusts as a remedy for fraud. See, e.g., Latham v. Father Divine, 299 N.Y. 22, 27, 85 N.E.2d 168, rehearing denied 299 N.Y. 599, 86 N.E.2d 114 (1949) ("a constructive trust will be erected whenever necessary to satisfy the demands of justice \* \* \* [I]ts applicability is limited only by the inventiveness of men who find new ways to enrich themselves unjustly by grasping what should not belong to them"); Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 389, 122 N.E. 378 (1919) ("when profits have been acquired in such circumstances that the holder of legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee"); Simonds v. Simonds, 408 N.Y.S. 2d 359, 380 N.E.2d 189 (1978) (citing Latham and Beatty with approval). This case presents the type of situation envisioned in Latham -- a wrongdoer by his "inventiveness" has found "new ways to \* \* \* grasp what should not belong to [him]."

The purpose of imposing a constructive trust is to prevent unjust enrichment. See Simonds 408 N.Y. S.2d at 364 (citing authorities). Here, Levine would certainly be unjustly enriched if he is allowed to satisfy his personal tax liabilities for his illegal actions at the expense of the very investors he defrauded. <sup>4/</sup>

A final requirement for imposition of a constructive trust is that the res be traceable to the proceeds of the fraud. See generally <sup>5</sup> Scott, The Law of Trusts, § 521 (3rd ed. 1967). Tracing the illegally obtained proceeds presents little problem

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<sup>3/</sup> New York law is the appropriate choice of law here since the illegal transactions took place in New York and Levine is a New York resident.

<sup>4/</sup> The Second Circuit has recognized that contemporaneous traders have a claim against the wrongdoer for profits from trading on inside information. Elkind v. Liggett and Myers, Inc., 635 F.2d 156 (2d Cir. 1980). Thus, all contemporaneous sellers of the stocks that Levine purchased may be viewed as victims of Levine's fraud.

here. More than 90% of Levine's disgorgement was obtained from his off-shore bank account used for the purpose of depositing profits from his illegal trading. The balance of the disgorgement is also traceable to the illegal trading. 5/

Under these circumstances, it is well within a court's discretion to declare a constructive trust with respect to the disgorgement proceeds in favor of the defrauded investors. 6/

### CONCLUSION

For the foregoing reasons, a court of equity has broad discretion either to grant the Commission an equitable lien having priority over the IRS tax lien as to the disgorgement fund, or to avoid the effect of the tax lien by imposing a constructive trust for the benefit of defrauded investors on the disgorgement proceeds.

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5/ A portion of the other assets turned over to the receiver can, according to Levine's own accounting, be traced directly to his illegal trading. The remainder can be traced to the illegal trading by employing the presumption utilized by the Commission in the Gary Martin case. That rule states that a wrongdoer is presumed to use his own assets before employing assets obtained by fraud. See National Bank v. Insurance Co., 104 U.S. 54 (1881) (adopting the rule of Knatchbull v. Hallett, L.R. 13 Ch.D. 696, that when a wrongdoer disposes of funds, some of which have been wrongfully obtained from others, he is presumed to have spent his own money first). Under this theory, to the extent that the disgorged funds came from a source other than the offshore bank account and had been commingled with other Levine assets, Levine may be presumed to have disgorged that portion of his assets representing illegal profits.

6/ In this discussion, we have looked to the state law of constructive trust because the IRS' right to seize property is governed by the taxpayer's state law rights to that property. We note that the Commission's rights, in exercising its enforcement powers, are not so limited by state law. Thus, we would consider urging, as an alternative to our state law constructive trust argument, that a person's rights to money obtained through violations of federal securities law are governed by federal common law. In this respect we would urge that a federal constructive trust doctrine should apply that may be broader than state law constructive trust principles.