DISGORGEMENT AS A VIABLE THEORY OF RESTITUTION DAMAGES

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When practitioners hear the word "restitution," what typically comes to mind is the adage of making a victim whole, often by restoring the individual or company to the position it held prior to the circumstances that led to a lawsuit. But what happens when the victim is a startup? What happens when, even after the victim recoups its losses, the defendant nevertheless remains in a better position than if it had not engaged in the wrongful conduct? In these situations, traditional damage recoveries are often incapable of ensuring justice, and courts must look to the law of restitution to protect legitimate goals of the judicial system.

Restitution is an expansive, dense area of law, and the authors endeavor to address only a slice of the topic, disgorgement, a remedy that will sometimes offer the claimant a greater recovery than the value of its compensatory or actual damages. Such recovery is available in limited circumstances – cases in which the defendant profited more from its wrongdoing than the value of the plaintiff's loss.

In reviewing the principles discussed in this article, readers should be mindful of the following archetypal fact pattern. Company A, a well-established concern with large shares of several markets, interviews an employee of Company B, a recently formed company with a narrow focus that has yet to turn a profit. During the interview, the employee discloses that he has access to Company's B's client lists and other proprietary information related to their narrow field. The employee is hired, Company A implements Company B's proprietary information into an existing product line and reaches out to each of Company B's clients, selling them on lower prices, which the established business is capable of offering due to its larger scale. The majority of Company B's clients transfer their business to Company A, which is able to turn a handsome profit on the new clients, including profits on goods that Company B does not produce.

Most commercial litigators would have little trouble rattling off available causes of action—tortious interference, misappropriation of confidential information, and aiding and abetting a breach of fiduciary duty are but a few. But, as your client has never turned a profit, what are its damages? This is where disgorgement law may be applicable.

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A DESCRIPTION AND APPLICABILITY OF DISGORGEMENT

All restitution claims, including those for disgorgement, share the same fundamental purpose: to "prevent the defendant's unjust enrichment by recapturing the gains the defendant secured in a transaction."[1] Traditional claims for damages seek to measure a claimant's loss and then compensate for that loss; restitution measures the defendant's gain and then requires the defendant to disgorge a sum equal to the gains that are traceable to the subject transaction or wrongdoing.[2] Restitution "effects the policy of discouraging tortious or wrongful conduct by depriving the wrongdoer of the opportunity to profit from wrongdoing."[3]

The *Restatement (Third) of Restitution and Unjust Enrichment* advocates that the remedy of disgorgement as a restitution theory should permit a claimant to recover "more than a provable loss so that the defendant may be stripped of a wrongful gain."[4] "Restitution requires full disgorgement of profit by a conscious wrongdoer . . . because any lesser liability would provide an inadequate incentive to lawful behavior."[5]

Therefore, when the law of restitution is correctly applied, a plaintiff is not prevented from seeking disgorgement damages as a result of her alleged inability to earn those profits themselves. For example, in *County of Essex v. First Union Nat'l Bank*,[6] the New Jersey Supreme Court permitted a plaintiff to recover disgorgement damages even where it suffered no damage as a result of the illegal conduct because "the reasons for disgorgement are not related to whether the [plaintiff] suffered damages."[7] Instead, as the court explained, "[i]t is the evil of the wrongdoer retaining any of the fruits of its wrongful conduct that grounds the claim."[8] Thus, when a defendant extracts a greater profit margin from misappropriated assets than their rightful owner, the

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[1] 1 DAN B. DOBBS, LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION § 4.1(1), at 551–52 (2d ed. 1993) (citing RESTATEMENT (FIRST) OF RESTITUTION § 1 (1937)).

[2] *See id.* at 555–56.

[3] Platinum Mgmt., Inc. v. Dahms, 666 A.2d 1028, 1045 (N.J. Super. Ct. Ch. Div. 1995); *see also* Zippertubing Co. v. Teleflex Inc., 757 F.2d 1401, 1411–12 (3d Cir. 1985) (in discussing the policy of discouraging tortious conduct by depriving the tortfeasor of the opportunity to profit from wrongdoing, the Court charged the jury: "That law says that when one has unlawfully deprived another of a contract or a business opportunity and has made that opportunity his own, he is not to be permitted to retain any of the profits, any of the benefits of its unlawful conduct.").

[4] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 3 cmt. a (emphasis added).

[5] *Id.* § 3 cmt. c.

[6] 891 A.2d 600, 607 (N.J. 2006) (upholding disgorgement of all fees paid on underwriting contract secured by bribery of public official, regardless of damage incurred as a result of bribery).

[7] *Id.* at 607.

[8] *Id.*

wrongdoers "should not be allowed to keep the difference, which was gained by their unlawful conduct."[9]

Likewise, the Supreme Court of Oklahoma's opinion in *Warren v. Century Bankcorporation, Inc.*[10] explains disgorgement's utility in situations where loss-based damage remedies are incapable of securing a just result. In *Warren*, Bankcorporation's minority shareholders sued the controlling parent company for having established a subsidiary in the business of issuing loans. In defending against the minority shareholder's derivative claims for unfair competition, the parent company argued that the subsidiary was designed to benefit Bankcorporation because the new loans would ultimately be sold to and serviced by Bankcorporation. Indeed, at trial, the parent adduced several studies showing that Bankcorporation had in fact benefited from the subsidiary's operations, along with evidence that Bankcorporation's revenues *increased* after the subsidiary began issuing loans. Invoking disgorgement principles, Oklahoma's high court correctly explained that the parent's "*argument misses the main point.*"[11] Regardless of whether the victim suffered an appreciable loss, the court explained that "*the fact remains that [the subsidiary] competed with the Bank*," wrongdoing best remedied through disgorgement, which "is designed to deprive the wrongdoer of all gains flowing from the wrong rather than to compensate the victim of the fraud."[12]

Determining whether conduct is "wrong," and thus remediable through disgorgement, is not typically answered by reference to the law of restitution but "normally incorporates as its predicate the substantive elements of a cause of action for tort or other breach of duty."[13] Therefore, when "a claimant seeks restitution of profits from conduct that may or may not be tortious, it is the tort law of the jurisdiction that formally decides the question of unjust enrichment."[14]

Authorities still disagree as to whether a claim for disgorgement constitutes an independent cause of action for restitution—often referred to as a claim for "unjust enrichment"—or a traditional tort claim that seeks disgorgement as

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[9] Vibra-Tech Eng'rs., Inc. v. Kavalek, 849 F. Supp. 2d 462, 496–98 (D.N.J. 2012) (disgorging all profits, even if the amount exceeded plaintiffs' lost profit calculation because defendants "should not be allowed to keep the difference, which was gained by their unlawful conduct. If the [defendants] were allowed to keep the difference, this would essentially allow them to benefit simply because they were able to obtain a better profit margin."); *See* Cross v. Berg Lumber Co., 7 P.3d 922, 935 (Wyo. 2000) (an accounting of profits is especially appropriate "where some other standard would not adequately compensate plaintiff in a case where an injustice has taken place, or to deter willful violations in the future. . . . Unless an accounting is made of defendants' profits, parties will be tempted to engage in the conduct at which the tort is aimed in the hope that they may profit from their own wrongdoing.").

[10] 741 P.2d 846 (Okla. 1987).

[11] *Id.* at 850.

[12] *Id.* at 850, 852.

[13] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt e.

[14] *Id.* § 3 cmt d.

an alternative remedy to compensatory damages.[15] The *Restatement's* position is that restitution is "a parallel source of liability" so that "the defendant . . . is liable both on a theory of tort and (alternatively) on a theory of unjust enrichment."[16]

In any event—whether understood as the basis for an independent restitutionary claim (e.g., a claim for quasi-contract) or a traditional tort for which a restitutionary remedy is available—the categories of misconduct that may give rise to a claim for disgorgement encompass most torts that arise in commercial litigation. The *Restatement* provides that the following categories of wrongdoing are remediable through disgorgement: inducing a transaction through fraud, misrepresentation, duress, or undue influence; committing an opportunistic breach of contract; committing trespass, conversion, and comparable wrongs; misappropriating financial assets; interfering with intellectual property and similar rights; breaching a fiduciary or confidential relation; and wrongfully interfering with donative transfer.[17] Moreover, courts across the nation have disgorged ill-gotten profits for such claims that commonly appear in commercial litigation.[18]

If the court determines that the defendant has profited from its wrongful conduct, and the claimant elects to calculate its recovery through disgorgement rather than damages, the ultimate inquiry asks how much must the defendant disgorge. Here, the court faces the "the apportionment problem," restitution's counterpoint to proximate cause in the law of damages.[19] In Professor Dan Dobbs's remedies treatise, often cited by courts in New Jersey and nationwide, he wrote "the principle is disgorgement, not plunder," and thus "courts have recognized that some apportionment must be made between those profits attributable to the plaintiff's property and those earned by the defendant's efforts

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[15] *Id.* § 1 cmt e.

[16] *Id.*

[17] *See id.* § 51 (defining the disgorgement remedy and the categories of misconduct for which it is available); § 13 (fraud and misrepresentation); § 14 (duress); § 15 (undue influence); § 39 (opportunistic breach); § 40 (trespass); § 41 (misappropriation of financial assets); § 42 (interference with intellectual property and similar rights); § 43 (fiduciary or confidential relation).The *Restatement* further provides a catch-all category in section 44, which encompasses "conscious interference with a claimant's legally protected interests."

[18] *See, e.g.*, Snepp v. United States, 444 U.S. 507 (1980) (disgorging profits made from sale of book, the publication of which breached a duty of loyalty owed to the claimant); Lincoln Nat. Life Ins. Co., 725 F.3d 406, 415 (3d Cir. 2013) (breach of fiduciary duty); Booth v. Stutz Motor Car Co. 56 F.2d 962 (7th Cir. 1932) (disgorging profits for plaintiff's misappropriation of confidential information, despite finding that the patent covering the information was invalid); Federal Sugar Ref. Co. v. United States Sugar Equalization Bd., 268 Fed. 575 (S.D.N.Y. 1920) (tortious interference with contract); Cross v. Berg Lumber Co., 7 P.3d 922, 935 (Wyo. 2000) (disgorging the rental value of a improperly converted piece of machinery); John A. Artukovich & Sons, Inc. v. Reliance Truck Co., 614 P.2d 327 (Ariz. 1980) (same); Nat'l Merch. Corp. v. Leyden, 370 Mass 425 (1976) (tortious interference with contract).

[19] DOBBS, *supra* note 1, § 4.5(3), at 641–44.

and investment, limiting the plaintiff to the profits fairly attributable to his share."[20] Still, a disgorgement calculation should focus exclusively on the defendant's gains—apportionment seeks to reduce the award by only those amounts that are fairly attributable to the defendant's enterprise, rather than its wrongdoing—and therefore the final award nevertheless "may have no logical relation to any damages that plaintiff actually suffered."[21]

PARTICULAR PROBLEMS IN SEEKING DISGORGEMENT IN NEW JERSEY

Despite a substantial amount of authority that recognizes disgorgement as a legitimate remedy under common law, including case law in New Jersey, many jurisdictions, including New Jersey, have yet to fully embrace application of this remedy. New Jersey courts' reluctance seemingly stems from two lines of cases that have been espoused by the state's appellate courts, notwithstanding that they appear to be at odds with black letter principles of restitution. In such cases, rulings reflect a common error made by courts whereby disgorgement is unnecessarily conflated with the common—and incorrect—notion that the law of restitution may only seek to make the victim whole by returning value that was lost.

In the first line of cases, courts seem to have limited claims for monetary restitution, including disgorgement, to instances where there is no adequate remedy of law. This position, which the *Restatement* drafters state "is simply wrong," derives from the view that "[r]estitution for unjust enrichment is an equitable remedy."[22] The Supreme Court of New Jersey has advanced this characterization of restitutionary claims, describing claims "based on theories of quantum meruit and quasi-contract" as "equitable claims."[23] Yet one could argue that unjust enrichment claims—or, quasi-contract claims, in New Jersey's parlance[24]—should be treated as an action at law. New Jersey courts "look to the historical basis for the cause of action and focus on the requested relief" in "determin[ing] whether an action is primarily legal ... or equitable."[25] Quasi-contract was an action at law under the common law because, as

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[20] *Id.* at 642.

[21] 1 Robert L. Dunn, Recovery of Damages for Lost Profits § 3.17(3).

[22] Nat'l Amusements, Inc. v. New Jersey Tpk. Auth., 619 A.2d 262, 267 (N.J. Super. Ct. Ch. Div. 1992) (citing State v. Singletary, 380 A.2d 302 (N.J. Super. Ct. Law Div.1977)), *aff'd*, 645 A.2d 1194 (N.J. Super. Ct. App. Div. 1994).

[23] Lyn-Anna Properties, Ltd. v. Harborview Dev. Corp., 678 A.2d 683, 689 (N.J. 1996).

[24] According to New Jersey's Appellate Division, "[u]njust enrichment is not an independent theory of liability, but is the basis for a claim of quasi-contractual liability." Nat'l Amusements, Inc. v. N.J. Tpk. Auth., 261 N.J.Super. 468, 478 (Law Div.1992), aff'd, 275 N.J.Super. 134 (App.Div.), certif. denied, 138 N.J. 269 (1994).

[25] Wood v. New Jersey Mfrs. Ins. Co, 21 A.3d 1131, 1138–39 (N.J. 2011).

Dobbs explains, ''quasi-contract was tied to the action in assumpsit and to the limited judicial powers of the law judges.''[26] Aptly, the *Restatement* states that ''there is no requirement that a claimant who seeks any [remedy in restitution] must first demonstrate the inadequacy of a remedy at law,'' and while ''[a]n argument to the contrary should appear antiquated today,'' a section of the *Restatement* is devoted to ''remov[ing] any doubt.''[27]

Second, courts have often required claimants to prove a common element of ''restitution'' damages—namely, that they ''conferred the benefit'' sought to be recovered through disgorgement, a requirement that often forecloses recovery of profits because such gains are not exactly ''conferred'' by the plaintiff. New Jersey's Supreme Court has held that a claim for unjust enrichment ''requires that [a claimant] show that it expected remuneration from the defendant at the time it performed or conferred a benefit on defendant.''[28] According to the *Restatement*, however, New Jersey courts are simply incorrect in adding this ''element'' to a claim in restitution. Indeed, the drafters directly address this holding in New Jersey law, writing that ''[f]amiliar statements to the effect that a cause of action for unjust enrichment or restitution requires ''a benefit conferred by the plaintiff on the defendant'' are seriously out of place in any discussion of restitution of wrongful gain.''[29]

Similar discussions on disgorgement, which advance a proposition at odds with traditional restitution principles, can be found throughout New Jersey's published opinions. For example, the Chancery Division recently stated that ''[d]isgorgement of profits is a punitive . . . form of damages,''[30] a proposition that has been completely rejected by secondary authorities.[31]

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[26] DOBBS, *supra* note 1, § 4.2, at 581.

[27] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 4 (2011).

[28] Iliadis v. Wal-Mart Stores, Inc., 922 A.2d 710, 723 (N.J. 2007). This statement can be seen in numerous decisions throughout all courts in New Jersey. *See*, *e.g.*, VRG Corp. v. GKN Realty Corp., 135 641 A.2d 519, 526 (N.J. 1994); Caputo v. Nice-Pak Products, Inc., 693 A.2d 494, 498 (N.J. Super. Ct. App. Div. 1997); Castro v. NYT Television, 851 A.2d 88, 98–99 (N.J. Super. Ct. App. Div. 2004); Fasching v. Kallinger, 510 A.2d 694, 699 (N.J. Super. Ct. App. Div. 1986) (agreeing with the trial court's decision to dismiss the plaintiff's unjust enrichment claim because ''the doctrine of unjust enrichment did not apply because plaintiffs never expected any remuneration from the publisher and the author and no direct relationship existed between the parties which would create a reasonable expectation of benefit''); Kleinman v. Merck & Co., Inc., 8 A.3d 851, 863 (N.J. Super. Ct. Ch. Div. 2009).

[29] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 3 cmt. a (2011). The text goes on to cite *Eli Lilly & Co. v. Roussel Corp.*, 23 F. Supp. 2d 460, 496 (D.N.J. 1998), ''for an example of this error'' in which the court '' dismiss[ed] a claim to profits earned as a result of defendants' fraud at claimant's expense, on the stated ground that the claimant 'has not alleged (nor could it prove) that it conferred a benefit on defendants.' ''). *Id.*

[30] Kleinman v. Merck & Co., 8 A.3d 851, 863 (N.J. Super. Ct. Ch. Div. 2009).

[31] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. k (''Disgorgement of wrongful gain is not a punitive remedy.''); DOBBS, *supra* note 1, § 4.1(4), at 567 (''Restitution may be more than compensation to the plaintiff but under most measures of restitution it is not more than the defendant's unjust gain in the transaction'' and ''[f]or this reason, such restitution is not punitive.'').

CONCLUSION

Disgorgement is a legitimate remedy that will hopefully become more firmly established in our nation's common law as time passes. For this to happen, when appropriate situations arrive before the court, judges will need to set forth in their opinions cohesive frameworks for applying the law of disgorgement. The Supreme Court of Wyoming's opinion in *Cross v. Berg Lumbar Co.* offers an excellent example of a court seizing an opportunity to clarify the law.

In many cases, an award of the victim's appreciable losses simply cannot effect justice. Consider again the hypothetical situation presented in this article's introduction, where startup Company B would be unable to prove damages, despite Company A's very blatant wrongdoing. A remedy of disgorgement could ensure that Company A would not be able to retain its ill-gotten gains.