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Practical Implications of Supreme Court's Decision Related to SEC's Disgorgement Remedy

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Disgorgement is the remedy the US Securities and Exchange Commission (SEC) has traditionally used to obtain alleged illicit gains in enforcement actions against public companies, registered investment advisers and broker dealers, and other market participants. Last week, in *Liu v. S.E.C.*, the Supreme Court held that the SEC may continue to seek disgorgement, but only where it does not exceed the defendant's net profits and where it qualifies as equitable relief. The decision answered a question explicitly left open in 2017, in *Kokesh v. S.E.C*, and preserved the SEC's ability to use disgorgement to obtain alleged illicit gains in enforcement actions. In doing so, the majority discussed the possibility that disgorgement awards may not be an equitable remedy (and thus not allowed under the relevant statute) where courts decline to deduct expenses from the award, impose joint-and-several liability, or fail to return money to investors.[1] Rather than resolve these issues, though, the Court in *Liu* provided some guidance and remanded to the lower court to determine how these principles apply in this case. The precise scope of the limitations to the disgorgement remedy thus remains to be seen and likely will be further defined in future litigation.

Still, *Liu* has immediate practical impact for parties negotiating resolutions with the SEC. In essence, the Court's decision outlines the potential limitations of the disgorgement remedy and provides a roadmap to parties to argue for a reduced disgorgement amount. As detailed below, while these limitations are significant to be sure and provide a sound basis for arguments to reduce disgorgement, parties must recognize that the SEC could respond by simply relying more heavily on its separate power to obtain statutory civil penalties to attempt to obtain financial relief in a different way. This alert details the Court's decision in *Liu* and discusses these practical implications for parties attempting to resolve cases with the SEC under this changed legal landscape.

BACKGROUND

Liu was a case involving petitioners Charles C. Liu and Xin Wang, a husband and wife who operated an investment fund through which they solicited foreigners to invest in American businesses so that the investors could qualify for immigrant visas. The pair purportedly raised money to build a cancer treatment center in California, but spent a substantial part of the fund's money on other projects. The SEC later brought suit, and the district court granted three forms of relief. Specifically, the court barred Liu and Wang from participating in a similar immigration investment fund, imposed a civil penalty, and ordered the pair to disgorge the full amount raised from investors (deducting only the money that was still in the corporate accounts for the project).

At issue in *Liu* was whether the court had the ability to order the disgorgement remedy and, more broadly, whether the SEC could seek disgorgement pursuant to its power to award "equitable relief" under Section 21(d)(5) of the Securities Exchange Act. That provision allows the SEC to request, and any Federal court to grant, "any equitable relief that may be appropriate or necessary for the benefit of investors."[2]

The *Liu* case follows *Kokesh v. SEC*,[3] decided by the Supreme Court in 2017, which held that disgorgement was a "penalty" for purposes of the five-year statute of limitations in 28 U.S.C. § 2462. In *Kokesh*, the Court explicitly left open whether the SEC could seek disgorgement in enforcement proceedings.[4] The petitioners in *Liu*, relying on *Kokesh*, argued that the Court should hold that the kind of disgorgement in the *Liu* case was a penalty and not the type of "equitable relief" that Section 21(d)(5) allowed.

SUMMARY OF DECISION

In an 8-1 decision, with Justice Sotomayor writing for the majority, the Court in *Liu* held that a disgorgement award qualifies as equitable relief that is permissible under federal law if it: (1) does not exceed a wrongdoer's net profits; and (2) is awarded for victims.[5] The majority based its decision on how courts of equity typically approached disgorgement, and among other things noted that equity courts historically limited disgorgement to the "net profits from wrongdoing after deducting legitimate expenses" and also would "circumscribe the award in multiple ways to avoid transforming it into a penalty," such as by imposing a constructive trust "on wrongful gains for wronged victims."[6]

The Court did not, however, definitively resolve the precise scope of when disgorgement is permissible. The majority cautioned that imposing joint-and-several liability in some circumstances could turn disgorgement into a penalty, and also observed that it was an "open question" regarding whether the SEC's practice of depositing disgorged funds with the US Treasury would "satisf[y] the SEC's obligation to award relief 'for the benefit of investors.'"[7] But the Court did not resolve those issues. Instead, the Court directed the Ninth Circuit on remand to determine whether Liu and Wang could, consistent with equitable principles, be found liable "as partners in wrongdoing or whether individual liability [would be] required." Similarly, because the record did not contain an order "directing any proceeds to the Treasury," the Court did not address the issue.[8]

Justice Thomas filed a dissenting opinion in which he agreed with the majority's decision not to affirm the lower court's decision, but explained that he would not have remanded to the lower court for further action. In Justice Thomas's view, "[d]isgorgement can never be awarded" under the statute because it cannot be correctly characterized as equitable relief.[9] He pointed to disgorgement only being a common law remedy since the twentieth century, with no connection to historical English courts or their remedies.

IMPLICATIONS FOR SEC ACTIONS

Although the precise scope of any of the limitations to the SEC's disgorgement power will be defined in future cases, *Liu* will still have immediate practical consequences for those facing enforcement actions filed by the SEC. The reality is that most SEC cases—especially those with public companies and registered broker dealers and investment advisers—settle prior to any litigation. Using the roadmap provided by the Court in *Liu,* parties will need to be prepared to argue how the potential limitations to disgorgement apply to the facts at issue.

First, parties will need to marshal arguments to prove that the disgorgement sought by the SEC exceeds the net profits traceable to the alleged wrongdoing. This could include, for example, carefully itemizing and documenting all expenditures, and arguing that more expenses be taken into account to appropriately reduce the disgorgement figure.

Second, parties may also seek to avoid disgorgement where the money at issue is not distributed to victim investors. As detailed above, *Liu* casts doubt on whether disgorgement, when collected and deposited with the US Treasury instead of being distributed to victims, is still consistent with equitable principles and “satisfies the SEC’s obligation to award relief ‘for the benefit of investors.’”[10] Recognizing this, the SEC in *Liu* had argued that depositing disgorgement with the US Treasury might still be justified “where it is infeasible to distribute the collected funds to investors.”[11] This infeasibility can occur, for example, when “numerous victims suffered relatively small amounts,” “where the victims cannot be identified,” or “where there are no victims entitled to damages,” and, in those situations, it was prior practice to deposit disgorgement with the US Treasury.[12] Despite questioning the practice, however, the Court in *Liu* declined to decide whether the practice could continue.[13] Thus, post-*Liu*, parties will have a principled basis to resist disgorgement where the SEC does not intend to distribute the money to investors.

Third, *Liu* also provides parties an argument to avoid disgorgement in instances of joint-and-several liability. In *Liu*, the Court noted that the SEC has sometimes used joint-and-several liability to “impose disgorgement liability on a wrongdoer for benefits” that accrued to others, which was “sometimes seemingly at odds with the common-law rule requiring individual liability for wrongful profits” and could “transform” an equitable remedy of disgorgement “into a penalty.”[14] Thus, parties may be able to resist disgorgement where the SEC is unable to individually trace any ill-gotten gains.

POSSIBLE GROWING ROLE OF CIVIL PENALTIES

In trying to limit the disgorgement amount, however, practitioners also should be aware that the SEC can impose civil monetary penalties on any person who violates or causes a violation of the securities laws. For example, the Securities Act of 1933 and the Securities Exchange Act of 1934 authorize three tiers of civil penalties, and the civil penalties imposed under these statutes can range from under $10,000 to over $1,000,000, per violation, after adjusting for inflation.[15] The SEC sometimes claims that one fraudulent scheme results in multiple violations and seeks a penalty for each violation. Moreover, in insider trading cases, a civil penalty statute authorizes the imposition of penalties up to triple the amount of any profits gained or losses avoided as a result of the unlawful trade.[16]

In adjusting to the new legal landscape, the SEC can be expected to rely more heavily on this power to seek civil penalties. This dynamic will be especially important in settled cases. Prior to *Liu*, the SEC prioritized obtaining full disgorgement in resolved cases and sometimes settled cases with only modest penalties. If application of *Liu* results in no disgorgement or limited disgorgement, the SEC can be expected to attempt to more aggressively assert the right to receive penalties in negotiations. Thus, while detailing arguments to reduce disgorgement, it is equally important that parties prepare to address the SEC’s expected argument that it can use the civil penalty statute to get financial relief in a different way.

IMPLICATIONS FOR FCPA ACTIONS

Some SEC actions—including FCPA actions—may be particularly impacted by the Court’s decision in *Liu*. In FCPA actions pre-*Liu*, the SEC would often seek disgorgement of any ill-gotten gains, including when enforcing the FCPA’s books and records provisions.

Post-*Liu*, however, the SEC’s ability to seek disgorgement in FCPA actions may be significantly limited. To begin with, it is often an impossible task to return money to harmed parties in FCPA actions because it is difficult to identify any specific victim. Consistent with this, during oral argument in *Liu,* Deputy Solicitor General Malcolm Stewart noted that the SEC often obtains “big judgments” in FCPA cases, but the funds are “not returned to investors because there really is no obvious universe of individual victims from an FCPA violation.”[17] Moreover, most FCPA actions involve situations where a company’s books and records are incomplete or unreliable, and separating the legitimate costs of business from any corrupt financial activity may be problematic. All of this may impact the SEC’s ability to obtain disgorgement from companies, even where the wrongdoing is undisputed.

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While it is clear that disgorgement can be equitable relief and the Court will allow such a practice in some limited circumstances, many open questions of SEC enforcement and securities law still remain regarding the definition and use of equitable relief in securities enforcement cases. It is thus for the lower courts to confront and determine how the practical effects of disgorgement play out in proceedings involving the SEC. In the meantime, parties will need to adapt to the changed legal landscape when resolving cases involving the SEC and would be wise to continue pressing challenges to disgorgement remedies wherever possible—at least until the Supreme Court says otherwise.

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[1] *Liu v. S.E.C.*, No. 18-1501, 2020 WL 3405845, at *1 (U.S. June 22, 2020).

[2] 15 U.S.C. §78u(d)(5) (2018).

[3] Jenner & Block was counsel for the successful appellant in this case.

[4] *Kokesh v. S.E.C.*, 137 S. Ct. 1635, 1642 n. 3 (2017).

[5] *Liu*, 2020 WL 3405845, at *1.

[6] *Id.* at *11.

[7] *Id.* at *5-11.

[8] *Id.* at *10.

[9] *Id.* at *12.

[10] *Id.* at *10.

[11] *Id.*

[12] *S.E.C. v. Lorin*, 869 F. Supp. 1117, 1129 (S.D.N.Y. 1994).

[13] *See e.g.*, *S.E.C. v. Drexel Burnham Lambert, Inc.*, 956 F. Supp. 503, 507 (S.D.N.Y.), *aff'd sub nom. S.E.C. v. Fischbach Corp.*, 133 F.3d 170 (2d Cir. 1997) (citations omitted).

[14] *Liu*, 2020 WL 3405845 at *1.

[15] 15 U.S.C. § 78u-2(b); 17 C.F.R. § 201.1001 and Securities and Exchange Commission, 'Inflation Adjustments to the Civil Monetary Penalties Administered by the Securities and Exchange Commission (as of January 2020)', *available at* https://www.sec.gov/enforce/civil-penalties-inflation-adjustments.htm (effective January 15, 2020). Maximum civil penalty amounts will be adjusted annually for inflation, as described in 17 C.F.R. § 201.1001.

[16] *See* 15 U.S.C. § 78u-1(a)(2).

[17] Transcript of Oral Argument at 35, *S.E.C. v. Liu*, No. 18-1501 (U.S. 2020), *available at* https://www.supremecourt.gov/oral_arguments/argument_transcripts/2019/18-1501_097c.pdf.

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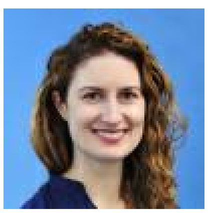

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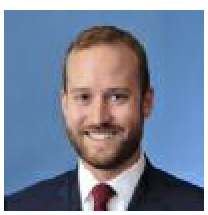

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