ALERT MEMORANDUM

Supreme Court Upholds, with Limits, the SEC's Authority to Seek Disgorgement

June 25, 2020

On June 22, 2020, the Supreme Court held in *Liu v. SEC* that the Securities and Exchange Commission ("SEC") may seek, and courts have the power to grant, disgorgement as an equitable remedy for violations of the securities laws.[1] However, the Court also placed potentially important limitations on disgorgement, holding that—to qualify as an equitable remedy and thus be allowable—disgorgement awards must accord with certain traditional equitable principles. While the Court left it to the lower courts to determine whether SEC disgorgement requests are in fact equitable on a case-by-case basis, it articulated guideposts calling into question the SEC's ability to obtain disgorgement that (1) exceeds a wrongdoer's net profits, (2) is not distributed back to victims, and (3) is awarded against multiple defendants on a joint-and-several basis.[2] Although the *Liu* decision preserves the SEC's ability to seek disgorgement—a central tenet of the SEC's enforcement program—it imposes a number of line-drawing questions on lower courts to consider. Depending on how the case law develops, these issues may serve both to increase the SEC's burden in making out disgorgement claims and to reduce the total dollar amounts of disgorgement awards the SEC is able to obtain, perhaps significantly.

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[1] *Liu et al., v. Securities and Exchange Commission*, 591 U.S. __, No. 18-1501, slip op. (June 22, 2020).
[2] *See id.*, slip op. at 1.

Background

The SEC has for decades obtained disgorgement of so-called "ill-gotten gains" from defendants who violate the Securities Exchange Act of 1934 ("Exchange Act") and other federal securities laws.[3] The SEC's basis for seeking this relief is Section 21(d)(5) of the Exchange Act, which permits the SEC to seek "any equitable relief that may be appropriate or necessary for the benefit of investors" for violations of the federal securities laws.[4] In the past decade, however, the Supreme Court has begun to place more stringent limits on the SEC's authority to seek monetary relief, including disgorgement. First, in 2013, the Court unanimously held in *Gabelli v. SEC* that 28 U.S.C. § 2462's five-year statute of limitations—which applies to the SEC's ability to impose penalties—runs from the date that the defendant's offending conduct occurs, not from the date that the SEC discovers it.[5] Then, in 2017, the Court unanimously held in *Kokesh v. SEC* that claims for disgorgement are likewise subject to § 2462's statute of limitations because they bear "all the hallmarks of a penalty."[6] In reaching its conclusion, the Court pointed out that—unlike traditionally equitable remedies that are designed to restore victims to the position they were in prior to the unlawful activity—the SEC seeks disgorgement in its role as an enforcement agency on the general public's behalf, can often require defendants to disgorge more than they personally profited, and does not always remit collected funds back to harmed investors.[7] Presaging the dispute in the *Liu* case, the *Kokesh* Court explicitly refused to determine whether federal courts are even authorized to order disgorgement in SEC cases.[8]

The *Liu* Case

The SEC charged Liu and his wife ("Petitioners") with making false and misleading statements to investors—in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act—in connection with soliciting investments in an EB-5 visa program.[9] In short, the SEC alleged that, in raising nearly $27 million from investors, Petitioners had disclosed that the bulk of their investments would be allocated to costs associated with building and equipping cancer treatment centers, when in fact Petitioners spent nearly $20 million on purported marketing expenses and salaries and otherwise transferred funds to accounts they controlled.[10] The SEC brought a civil enforcement action in the Central District of California, seeking, among other relief, disgorgement equal to the full amount that the Petitioners raised from investors.[11] The District Court, on summary judgment, held the Petitioners jointly and severally liable for the entire amount. In doing so, the District Court rejected Petitioners' argument that the disgorgement award improperly failed to account for their legitimate business expenses, instead finding that the SEC's requested disgorgement award constituted a "reasonable approximation of the profit causally connected to [their] violation."[12] The Ninth Circuit affirmed.[13] On November 1, 2019, the Supreme Court granted certiorari "to determine whether [§ 21(d)(5) of the Exchange Act] authorizes the SEC to seek

[3] *See, e.g.*, *SEC v. Tex. Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971); *SEC v. First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989).
[4] 15 U.S.C. § 78u(d)(5).
[5] *See Gabelli v. SEC*, 568 U.S. 442, 454 (2013).
[6] *Kokesh v. SEC*, 137 S. Ct. 1635, 1644 (2017).
[7] *See id.* at 1643.
[8] *Id.* at 1642 n.3 ("Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to § 2462's limitations period.").
[9] The EB-5 program permits noncitizens to apply for permanent residence in the United States by investing in approved commercial enterprises that are meant to promote economic growth. The program is administered by the U.S. Citizenship and Immigration Services, and investments in EB-5 projects "are subject to the federal securities laws." *Liu*, slip op. at 4.
[10] *Id.*
[11] *Id.* at 5.
[12] *Id.*
[13] *Id.*

disgorgement beyond a defendant's net profits from wrongdoing."[14]

The Supreme Court's Decision

In an 8–1 decision, the Court held that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under § [21(d)(5)]."[15] The Supreme Court rejected the main thrust of Petitioners' argument—that because disgorgement was, under *Kokesh*, a penalty, it could not also constitute an equitable remedy allowable under Exchange Act Section 21(d)(5). Justice Sotomayor, writing for the majority, rooted the Court's opinion in two equity principles: first, that equity practice has "long authorized courts to strip wrongdoers of their ill-gotten gains," and second, that to avoid turning an equitable remedy into a punitive sanction, courts have historically restricted equity remedies to an individual wrongdoer's net profits and awarded them to victims.[16]

The Court expressed concern that there are three ways in which the SEC's current practices of obtaining disgorgement awards "cross[] the bounds of traditional equity practice."[17]

First, the Court addressed what the SEC does with obtained disgorgement proceeds.[18] While the SEC often seeks to distribute collected funds back to harmed investors, it retains discretion to determine whether, instead, to remit them to the U.S. Treasury so that they may be used for other purposes, including to pay bounties to whistleblowers or to fund the activities of the Inspector General.[19] Looking to the Exchange Act's language that the SEC "may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary *for the benefit of investors*," the Court observed that "[t]he equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for their benefit."[20] However, the Court declined to adopt a bright-line rule regarding the practice of depositing disgorged funds with the Treasury, and held that "[i]t is an open question whether, and to what extent, that practice nevertheless satisfies the SEC's obligation to award relief 'for the benefit of investors' and is consistent with the limitations of § [21(d)(5)]."[21] The Court noted that, in future cases, to demonstrate that disgorgement was "appropriate and necessary," the SEC could not simply argue that the mere existence of a disgorgement order—irrespective of whether funds were to be distributed to harmed investors—sufficiently "benefit[ed] the public at large by virtue of depriving a wrongdoer of ill-gotten gains."[22]

Second, the Court addressed the SEC's practice of imposing liability for disgorgement on a joint-and-several basis against co-defendants.[23] The Court acknowledged that the common law "permit[ted] liability for partners engaged in concerted wrongdoing."[24] Nonetheless, the Court admonished that this practice can impermissibly "transform any equitable profits-focused remedy into a penalty," since co-defendants can be held liable not just for the profits that have accrued for themselves, but also for the profits of others with whom they did not closely participate in a fraudulent scheme.[25] Again, declining to adopt a bright-line rule, the Court recognized that participants and beneficiaries of unlawful schemes may be in a "wide spectrum of relationships," and refused to "wade into all the circumstances" that may make joint-and-several liability punitive rather than equitable.[26] Instead, it left to the lower courts the task of determining the circumstances in which individual, rather than collective, liability is appropriate.[27]

[14] *Id.*
[15] *Id.* at 1.
[16] *See id.* at 6.
[17] *Id.* at 14.
[18] *See id.* at 14–17.
[19] *See id.* at 14–15.
[20] *Id.* at 15–16 (emphasis added).
[21] *Id.* at 16–17.
[22] *Id.* at 16.
[23] *Id.* at 17–18.
[24] *Id.* at 18.
[25] *Id.* at 17.
[26] *Id.*
[27] *Id.*

Third, the Court addressed whether the amount of disgorgement should be offset by the defendant's expenses.[28] The Court firmly held that courts "must deduct legitimate expenses before ordering disgorgement under § [21(d)(5)]."[29] The Court acknowledged that there may be instances in which expenses should not be deducted because they were "incurred for the purposes of furthering an entirely fraudulent scheme," such as where "the entire profit of a business or undertaking results from the wrongdoing."[30] However, the Court held that in determining whether expenses can be deducted from a disgorgement amount and remain consistent with the equitable principles underlying § 21(d)(5), courts must ascertain whether expenses are "legitimate" or "whether they are merely wrongful gains under another name."[31]

Observations

The Court's decision is likely a source of guarded relief for the SEC's Enforcement Division in that it avoided a worst case scenario. The decision was not unexpected, as oral argument suggested widespread agreement among the Justices that disgorgement in some form was permissible under Section 21(d)(5). Nonetheless, a contrary holding would have significantly curtailed the SEC's enforcement powers.[32]

Still, the decision is plainly not an unalloyed success for the agency. Depending on how additional litigation in the lower courts turns out, *Liu* may substantially raise the burden on the SEC when seeking disgorgement.

Questions raised by the *Liu* decision that will need to be worked out in the coming years include:

— *Does disgorgement need to be distributed to victims in every case?* The Court left open the question of whether distributing funds to the Treasury meets Section 21(d)(5)'s requirement that disgorgement be "for the benefit of investors," including in situations where it is not feasible for the SEC to distribute the collected disgorgement amounts to victims.[33] The Court reasoned that lower courts are "well equipped to evaluate the feasibility of returning funds to victims of fraud."[34] During oral argument, Chief Justice Roberts stated that "investors should be pretty easy to find if there's money available."[35] However, this assumption may not always hold true. There are subsets of cases where, because of the nature of the fraud, identifiable victims may not exist. For example, in insider trading cases and cases brought pursuant to the Foreign Corrupt Practices Act—which together comprise about 9% of the SEC's total enforcement cases[36]—it can be very difficult, if not impossible, to identify individual victims. In other cases, where many investors invested small sums of money, the costs and administrative burdens associated with a distribution fund may, at least in the SEC's view, outweigh the benefits of distribution. Does this mean that, in such actions, defendants cannot be deprived of their wrongful gains? Lower courts will need to grapple with the implications of this holding.

— *What types of expenses are legitimately deductible from disgorgement amounts?* To date, courts have

[28] *Id.* at 18–20.
[29] *Id.* at 19.
[30] *Id.* (internal quotation marks and citation omitted).
[31] *Id.* (internal quotation marks and citation omitted). The Court did not determine whether the Petitioners' expenses in *Liu* were legitimate, leaving that task for the lower courts, but noted "that some expenses from [P]etitioners' scheme went toward lease payments and cancer-treatment equipment," and that "[s]uch items arguably have value independent of fueling a fraudulent scheme." *Id.*

[32] Disgorgement awards constitute a critical piece of the SEC's enforcement program. For example, in fiscal year 2019, the SEC obtained $3.248 billion in disgorgements, representing almost 75% of all monetary relief awards. *See* Division of Enforcement, *2019 Annual Report* at 16, SEC (2019), available at https://www.sec.gov/files/enforcement-annual-report-2019.pdf.
[33] *Liu*, slip op. at 15–16.
[34] *Id.* at 16 n.5.
[35] *Liu*, Transcript of Oral Argument at 24.
[36] *2019 Annual Report*, *supra* note 32, at 15.

allowed the SEC considerable latitude in determining the amount of the defendant's unlawful gain, requiring only a "reasonable approximation" of that amount.[37] This served, in many cases, to shift the burden to defendants to disprove the SEC's precise calculations. The Court's holding in *Liu* that lower courts must deduct legitimate expenses appears to ratchet up the burden of proof on the SEC. Further, it is unclear what constitutes "legitimate" expenses, and whether they must be incurred in a process that is entirely distinguishable from the fraudulent conduct. For example, if a company that otherwise operates lawfully raises money in a fraudulent way (e.g., through false statements during an offering), but spends the funds it raises on legitimate business expenses or in the ways it disclosed, must the amount of those expenses be deducted from any disgorgement award? This is another area that lower courts will need to resolve, and that may well increase the SEC's discovery and litigation burdens, or, indeed, result in lower disgorgement awards.

— *Is joint-and-several liability off the table for all but the most closely-related defendants?* While the Court was certainly critical of holding defendants responsible for each other's unlawful gains, it is unclear how close the relationship between participants and beneficiaries of unlawful schemes must be in order to make it appropriate to apply joint-and-several liability. For example, although lower courts have held in insider trading actions that "[i]t is well settled that a tipper can be required to disgorge his tippee's profits,"[38] the Court in *Liu* described the tipper-tippee relationship as "remote" and "unrelated."[39] If such a relationship is not close enough to justify joint-and-several liability, then tippers who improperly disseminate material nonpublic information may no longer be liable for the disgorgement of their tippees' ill-gotten gains. In any event, establishing the relationship between co-defendants may require more work and discovery by the SEC in litigated cases going forward.

— *How will Liu's holding affect settled actions?* The vast majority of SEC enforcement actions are not litigated in court, but instead filed as settled actions. While the full implications of *Liu* are unclear, it would appear to give putative defendants new tools to negotiate for lower disgorgement awards. Presumably parties will now routinely attempt to show legitimate business expenses that should properly be deducted—but will parties also push the Commission Staff to demonstrate whether it can (and will) distribute such gains back to victims? And, if not, are such disgorgement orders appropriate even in a settled context? The answers to these questions will likely take shape over a period of years as the lower courts grapple with varying fact patterns. But the above open questions and the additional work that the SEC may need to do to obtain disgorgement may give defendants more leverage to negotiate smaller disgorgement awards.[40]

— *Is disgorgement always a penalty?* Somewhat ironically, the Court pointed to a number of disgorgement features it had cited in *Kokesh*—there, to find that disgorgement was a penalty subject to the five-year statute of limitations, and here, to explain that these features may need to be eliminated to make disgorgement awards a legitimate exercise of a court's equitable powers. For example, in *Kokesh*, the Court pointed to both (1) the SEC's discretion as to whether to return ill-gotten gains to investors, and (2) its ability to obtain disgorgement of more than a defendant's

[37] *Id.* at 5.
[38] *Liu*, slip op. at 17 (quoting *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990)).
[39] *Id.* at 18.
[40] Notably, however, the *Liu* decision does not affect the SEC's ability to seek or obtain civil monetary penalties, which presumably will continue to be a point of negotiation for parties seeking to resolve enforcement matters with the SEC. Moreover, the amount of gross profits is often subject to debate and negotiation in settled matters, such that SEC Staff may argue for higher gross profit amounts to be reduced by expenses.

actual gain through joint-and-several orders as features of the penal nature of the SEC's disgorgement authority. However, the Court suggests in *Liu* that both may now be off the table. It seems highly unlikely—for a number of reasons based both in the wording of *Kokesh* and programmatically—that the SEC will now argue that disgorgement orders shorn of these features are no longer penalties subject to the five-year statute of limitations. Nonetheless, the Court seems to be grappling with the somewhat unique features of the SEC's public-enforcement program, which distinguish the SEC from private plaintiffs. Moreover, *Liu* may further highlight, from the SEC's perspective, the desire for a legislative fix, for example, in the form of either an explicit disgorgement or restitution statute.[41]

In sum, *Liu* is something of a "glass half full" result for the SEC. It clearly avoided a worst-case-scenario finding that it lacked all disgorgement authority. Nonetheless, the SEC will now likely face increased burdens and a greater use of resources in litigated cases, as well as pushback on proposed disgorgement in settled cases. As lower courts resolve the many questions that *Liu* has left unanswered, we will likely see the effects of the Court's decision for years to come.[42]

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[41] It should be noted that the SEC has sought such statutory relief, unsuccessfully, in the past. For example, last year, SEC Chairman Jay Clayton publicly noted his support for the opportunity to work with Congress to address the "substantial amount of losses" that the SEC would not be able to recover in "long-running, well-concealed frauds" due to the five-year statute of limitations. Jay Clayton, Chairman, SEC, Keynote Remarks, Mid-Atlantic Regional Conference (June 4, 2019).

[42] This Alert Memorandum was prepared with the assistance of Cleary Gottlieb associates Daniel Montgomery and Victoriya Levina.