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Supreme Court Pares Back the SEC's Disgorgement Remedy

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White Collar Defense and Investigations, Anti-corruption/FCPA, Securities Litigation and Enforcement

On June 22, 2020, in *Liu v. SEC*, the U.S. Supreme Court, by an 8-1 majority, upheld the SEC's decades-old practice of seeking disgorgement of ill-gotten gains from securities law violators in civil enforcement actions filed in federal district court. The SEC's victory, however, was tempered by the Court's insistence that disgorgement must be strictly limited to each defendant's net unlawful profit and be for the benefit of victims. The Court held that these principles are in tension with several elements of the agency's long-standing approach to disgorgement. The decision provides significant new grounds on which defense counsel can seek to reduce—or even eliminate—the disgorgement sought by the SEC in settlement discussions or litigation.

The question addressed in *Liu* was teed up by the Supreme Court three years ago in *Kokesh v. SEC*, in which the Court tantalized defense counsel by dropping a footnote questioning, but not deciding, whether the SEC has statutory authority to seek disgorgement at all in federal court actions.[1] The relevant statute—Section 21(d)(5) of the Securities Exchange Act of 1934—empowers the SEC to seek in such actions "any equitable relief that may be appropriate or necessary for the benefit of investors." In *Liu*, Justice Sotomayor, writing for the Court, held that the statute's reference to "equitable relief" includes disgorgement.[2] Justice Thomas, in a solo dissent, argued that disgorgement is not a traditional equitable remedy.[3]

With that fundamental issue resolved in the SEC's favor, the true significance of the decision is the general guidance it provides about the scope of the SEC's disgorgement remedy, leaving much in the way of details to be debated and decided in future cases. Here are the key issues:

Deductibility of Business Expenses

In calculating disgorgement, the SEC historically refused in many cases to deduct certain business expenses and trading commissions from defendants' alleged profits, on the theory that it would be unjust for defendants to benefit from expenses incurred to defraud investors. In *Liu*, the SEC contended that a married couple had misappropriated millions of dollars raised from

[1] *Kokesh v. SEC*, 137 S. Ct. 1635, 1642 n.3 (2017).

[2] *Liu v. SEC*, No. 18-1501, 2020 WL 3405845, at *2 (U.S. June 22, 2020).

[3] *Id. at* *12 (Thomas, J., dissenting).

investors to build cancer treatment centers under the EB-5 Immigrant Investor Program.[4] The lower courts had approved the SEC's request, consistent with its past practice in offering fraud cases, for disgorgement equal to the full amount raised from investors, less the remaining balance in the corporate accounts for the project.[5] The Supreme Court, however, made clear that for disgorgement to be an equitable remedy, it must be measured by the defendants' *net* profits, which required the deduction of legitimate business expenses.[6] The Court did not define how net profits should be calculated or which business expenses may be appropriately deducted. We expect those issues to be litigated in future cases. In addition, the Court noted an exception to the deductibility rule for wholly fraudulent enterprises, but emphasized that the exception was limited to situations where defendants sought to reduce the net proceeds by claiming "unconscionable" expenses such as personal or living expenses.[7]

Joint-and-Several Liability

The Court also disapproved of the SEC's longstanding practice of imposing joint-and-several liability on wrongdoers for ill-gotten gains received by other participants in a fraudulent scheme. Generally, the Court ruled that this approach is at odds with the traditional equity principle limiting recovery to profits that accrued to each defendant, as opposed to other participants or beneficiaries. The Court added that collective liability may be appropriate where partners are engaged in concerted wrongdoing, but declined to "wade into all the circumstances where an equitable profits remedy might be" inappropriate "[g]iven the wide spectrum of relationships between participants and beneficiaries of unlawful schemes."[8] On the facts of *Liu*, the Court remanded to the Ninth Circuit to determine whether the petitioners can, consistent with equitable principles, be found liable for profits as partners in wrongdoing or whether individual liability is required.[9]

FAIR Funds

Justice Sotomayor noted that "[t]he equitable nature of the profits remedy generally requires the SEC to return a defendant's gain to wronged investors for their benefit."[10] The Court noted that this principle may conflict with the SEC's practice of depositing disgorged funds with the U.S. Treasury rather than returning them to victims in so-called FAIR Funds, when the agency determines that a distribution to investors is not feasible.[11] The Court's rationale would seem to undermine this practice, but the decision declines to decide the issue and directs lower courts to

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[4] *Id.* at *4.

[5] *Id.* at *4.

[6] *Id.* at *8.

[7] *Id.*

[8] *Id.* at *11.

[9] *Id.* at *12.

[10] *Id.* at *9.

[11] *Id.* at *9–10.

consider whether an order depositing disgorged funds with the Treasury would benefit investors as required by the statute.

FCPA Cases

The FAIR Funds issue could have a substantial impact on FCPA cases, where victims are typically difficult, if not impossible, to identify. If lower courts rule that disgorgement would be inappropriate where funds cannot be returned to victims, disgorgement could therefore become unavailable in SEC federal court actions alleging FCPA violations, and perhaps also in SEC administrative proceedings (discussed below). Even if disgorgement is ultimately permitted in FCPA cases, *Liu* should provide corporate defense counsel with greater leverage in settlement discussions potentially to deduct a wider range of expenses to reach the disgorgeable net profits amount, depending on how lower courts define the concepts of appropriate business expense deductions, "overhead" expenses, and net profits for purposes of disgorgement. On the other hand, to the extent that the SEC's disgorgement authority becomes constrained in FCPA enforcement actions, the SEC may seek higher civil penalties, which can be assessed at the gross amount of the pecuniary gain to the defendant as a result of the violations under the FCPA's accounting provisions.[12]

Insider Trading Cases

Before *Liu*, the SEC sometimes required tippers to disgorge the profits of tippees who traded on information that they provided. Now the SEC may be limited to seeking from tippers only profits that they actually receive, such as in the form of a kickback from a tippee. Moreover, the SEC frequently does not distribute disgorgement in insider trading cases to victims, who are often difficult to identify. If lower courts decide that the SEC cannot recover disgorgement and pay it to the government, disgorgement may be denied altogether in insider trading cases. In that event, the SEC might attempt to compensate for the loss of disgorgement by seeking higher civil penalties, which in insider trading cases may be up to three times the amount of the unlawful trading profits.[13]

SEC Administrative Proceedings

Unlike in federal court actions where the SEC's authority includes "equitable relief," the agency has explicit statutory authority to seek "disgorgement" in administrative proceedings.[14] *Liu* was decided in a court action, and the Court left open the possibility that disgorgement principles applicable in federal court actions may differ from those that apply in administrative proceedings.[15] It remains to be seen whether the SEC will seek a more expansive definition of disgorgement in administrative proceedings.

Liu thus provides a measure of victory for both the SEC and for defense counsel representing clients in SEC enforcement actions. The SEC retains its general ability to seek disgorgement,

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[12] 15 U.S.C. § 78u(d)(3).

[13] 15 U.S.C. § 78u-1(a)(2).

[14] *See, e.g.*, 15 U.S.C. §§ 77h-1(e), 78u-2(e), 78u-3(e).

[15] *Liu*, 2020 WL 3405845, at *8–9.

one of its key enforcement tools, while defense counsel are now armed with additional powerful arguments to resist or reduce disgorgement awards in settlement discussions or litigation.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our White Collar Defense and Investigations, Anti-corruption/FCPA, Securities Litigation and Enforcement practices:

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