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Supreme Court Upholds the SEC's Authority to Seek Disgorgement in Civil Actions, But Imposes Important Limiting Principles

This week, the Supreme Court held that the SEC may seek disgorgement in enforcement actions, at least when the disgorgement does not exceed a wrongdoer's net profits and is to be awarded for victims. In *Liu* v. *Securities & Exchange Commission*, the Supreme Court addressed whether the SEC may seek disgorgement pursuant to its statutory authority under 15 U.S.C. § 78u(d)(5) to obtain equitable relief. In an earlier decision, *Kokesh* v. *Securities & Exchange Commission*, the Supreme Court had characterized disgorgement as a "penalty" under the general federal statute of limitation applicable to the enforcement of penalties.[1] *Kokesh* had arguably called into question whether disgorgement constitutes equitable relief for purposes of the SEC's statutory authority, and thus set the stage for *Liu*.

In *Liu*, the Supreme Court upheld courts' equitable authority to award disgorgement in SEC enforcement actions, but held that to be valid, the awards should adhere to the following principles: (1) the amount disgorged must not exceed the wrongdoer's net profits, (2) the disgorgement must be obtained for the benefit of investors, and (3) a disgorgement order against affiliates may be unjust depending on certain enumerated circumstances. The Court's decision provides welcome guidance in area where there previously was a limited basis for challenging the discretion of the SEC, and provides potential defendants in SEC enforcement proceedings with clear grounds for resisting unreasonable disgorgement demands.

Factual and Procedural Background of *Liu*

The SEC brought a civil enforcement action against petitioners Charles C. Liu and Xin Wang (among others), alleging that they violated the federal securities laws by fraudulently raising approximately $27 million from investors and then misappropriating the funds.[2] A federal district court in California entered summary judgment for the SEC and awarded disgorgement of over $26 million, in addition to other relief.[3] Petitioners objected that the disgorgement award failed to exclude their legitimate business expenses.[4] The district court, however, disagreed; it ruled that the sum was a "reasonable approximation of the profits causally connected to their violation."[5] Under the district court's ruling, petitioners were jointly and severally liable for the full disgorgement award of $26 million.[6]

The Ninth Circuit affirmed. On appeal, petitioners argued that the Supreme Court's intervening decision in *Kokesh* precluded the SEC from seeking disgorgement in civil enforcement proceedings.[7] The Ninth Circuit disagreed. As the Ninth Circuit explained, the *Kokesh* Court had declined to address whether the SEC was authorized to seek disgorgement as a remedy. The Ninth Circuit therefore applied the circuit's

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"longstanding precedent on this subject," which permitted the award.[8] In the Ninth Circuit's view, the "proper amount of disgorgement" was "the entire amount raised less the money paid back to investors."[9]

The Supreme Court granted review to consider "[w]hether the Securities and Exchange Commission may seek and obtain disgorgement from a court as 'equitable relief' for a securities law violation even though this Court has determined that such disgorgement is a penalty."[10]

The Supreme Court's Decision

In an 8-1 decision written by Justice Sotomayor, the Supreme Court rejected petitioners' argument that disgorgement is not a permissible remedy under 15 U.S.C. § 78u(d)(5).[11]

15 U.S.C. § 78u(d)(5) permits courts to award "any equitable relief that may be appropriate or necessary for the benefit of investors" in civil enforcement actions brought by the SEC. Because Congress did not define what remedies constitute "equitable relief," the Court analyzed whether disgorgement was *typically* available in courts of equity. In rejecting petitioners' argument that the SEC has no authority to seek disgorgement under § 78u(d)(5), the Court noted that "[e]quity courts have routinely deprived wrongdoers of their net profits from unlawful activity, even though that remedy may have gone by different names," such as restitution or accounting for profits. The Court further observed that courts sitting in equity have generally awarded profits-based remedies against individuals or partners engaged in concerted wrongdoing, not against multiple wrongdoers under a joint-and-several liability theory.[12] The Court also explained that its decision in *Kokesh* that disgorgement was a "penalty" for statute of limitations purposes under 28 U.S.C. § 2462 had no bearing on whether disgorgement was "equitable relief" under 15 U.S.C. § 78u(d)(5). A disgorgement remedy could, and does, qualify as both.

At the same time, the Court rejected the SEC's argument that it can obtain broad disgorgement remedies unconstrained by traditional equitable principles.[13] The Court observed that, "[o]ver the years . . . courts have occasionally awarded disgorgement in three main ways that test the bounds of equity practice."[14] Specifically, courts have (1) "fail[ed] to return funds to victims," (2) "impose[d] joint-and-several liability," and (3) "decline[d] to deduct business expenses from the award."[15] The Court did not determine whether the disgorgement award below suffered from any of those three deficiencies. The Court instead provided "principles that may guide the lower courts' assessment" of those issues on remand.[16]

First, the Court indicated that "[t]he equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors."[17] The Court left open whether depositing the proceeds of disgorgement with the United States Treasury, rather than returning those proceeds directly to victims, might be justified where it is "infeasible to distribute the collected funds to investors."[18] The Court observed that, if the SEC requests an order on remand directing proceeds to the Treasury, "the lower courts may evaluate in the first instance whether that order would indeed be for the benefit of investors," as required by statute.[19] The Court also observed that, "[t]o the extent that feasibility is relevant at all to equitable

principles," "lower courts are well equipped to evaluate the feasibility of returning funds to victims of fraud."[20]

Second, the Court raised the possibility that imposing joint and several liability for disgorgement may be impermissible depending on the circumstances. The Court declined "[to] wade into all the circumstances where an equitable profits remedy might be punitive," but it contrasted "equally culpable codefendants" with "more remote, unrelated tipper-tippee arrangements."[21] With respect to petitioners, the Court identified their marriage and the lack of evidence that they did not commingle funds as facts relevant to whether "petitioners [could] be found liable for profits as partners in wrongdoing or whether individual liability is required."[22] The Court left the task of weighing those and other considerations on remand.[23]

Third, the Court held that "courts must deduct legitimate business expenses before ordering disgorgement under § 78u(d)(5)."[24] It noted that a defendant may be denied "'inequitable deductions' such as for personal services."[25] But "the exception requires ascertaining whether expenses are legitimate or whether they are merely wrongful gains 'under another name.'"[26] As the Court noted, certain of petitioners' expenses went toward items that "arguably [had] value independent of fueling a fraudulent scheme," such as payments for a lease and business equipment.[27] The Court left resolution of whether those expenses should be deducted from the disgorgement amount in this case to the lower courts.[28]

Justice Thomas dissented. In his view, "[d]isgorgement can never be awarded under 15 U.S.C. § 78u(d)(5)" because the SEC may only seek "equitable relief" under that section, and "disgorgement is not a traditional equitable remedy."[29]

Implications of the Supreme Court's Decision

While the Supreme Court held in *Liu* that the SEC may as a matter of principle seek disgorgement under 15 U.S.C. § 78u(d)(5), the decision circumscribes the authority of courts to enter disgorgement awards. After *Liu*, disgorgement is generally permissible only when the award (1) represents the net profits of the wrongdoer, (2) is awarded for the benefit of victims, and (3) is not directed at affiliates of the wrongdoer if an award against the affiliates would be punitive. The decision thus imposes much-needed standards that the SEC must follow in seeking disgorgements.

In holding that the SEC is permitted to obtain only the net profits of the wrongdoer, the Supreme Court distinguished between "legitimate expenses," which may be deducted from a disgorgement remedy, and "inequitable deductions such as for personal services."[30] But the Court left open how a district court might distinguish between the two. The Court also did not address which party has the burden of proving whether expenses should be excluded from a disgorgement award.

The Court's pronouncement that any disgorgement should generally benefit victims also left open certain questions, including whether and in what circumstances the decision to deposit disgorged funds in the

Treasury would benefit victims of the fraud, as required by statute and equitable principles. It is not clear how this new factor will impact the SEC's efforts to seek disgorgement, and the SEC may issue further guidance as a result. Defendants may be able to argue that, if funds cannot be returned to victims directly—or if there are no apparent victims to compensate, such as in certain FCPA and insider trading cases—then disgorgement cannot be ordered at all.

The decision also may assist defendants who are seeking to settle parallel actions by the SEC and private plaintiffs in class or derivative securities actions. With the SEC obligated to disburse disgorgement proceeds to victims, defendants may have a stronger argument that any settlement with class or derivative plaintiffs must take into account any disgorgement award entered in the SEC action.

On the issue of joint and several liability for disgorgement, the Court declined to "wade into all the circumstances where an equitable profits remedy might be punitive when applied to multiple individuals."[31] But it did provide some guidance on the types of factors that lower courts should consider in determining whether to impose disgorgement on affiliates of the wrongdoer. Those factors include (1) the role of the affiliate in the misconduct forming the basis of the disgorgement award, i.e., whether the affiliate is an active participant or a "mere passive recipient"; (2) whether the finances of the individual wrongdoer and affiliate are commingled, or whether the affiliate did not enjoy the "fruits of the scheme"; and (3) "other circumstances [that] would render a joint and several disgorgement order unjust."[32] The Court did not, however, provide guidance on what such "other circumstances" might be. This raises additional important questions that the SEC will have to consider in deciding whether to seek disgorgement against certain corporate entities, such as whether to seek disgorgement against a parent corporation for the conduct of a subsidiary, or one joint venture partner for the conduct of another joint venture partner. Notably, the Court also hinted that a "more remote, unrelated tipper-tippee arrangement[]" might not support a joint and several disgorgement remedy,[33] which may open the door for some tippers in insider-trading cases to argue that they should not be liable for the profits of tippees. The Court's decision thus provides defense counsel with important tools for pushing back against disgorgement remedies that do not satisfy the *Liu* standard.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] 137 S. Ct. 1635 (2017).

[2] Petition for Writ of Certiorari at 4, *Liu* v. *SEC*, No. 18-1501, 2020 WL 3405845 (U.S. June 22, 2020).

[3] *Id.* at 5-6.

[4] Defendants' Memorandum in Opposition of SEC's Motion for Summary Judgement at 25, *SEC* v. *Liu*, 262 F. Supp. 3d 957 (C.D. Cal. 2017).

[5] *SEC* v. *Liu*, 262 F. Supp. 3d 957, 976 (C.D. Cal. 2017), *aff'd*, 754 F. App'x 505 (9th Cir. 2018), *vacated and remanded*, No. 18-1501, 2020 WL 3405845 (U.S. June 22, 2020).

[6] *Id.* at 975-76.

[7] *See SEC* v. *Liu*, 754 F. App'x 505, 509 (9th Cir. 2018).

[8] *Id.*

[9] *Id.*

[10] Petition for Writ of Certiorari at i, *Liu*, 2020 WL 3405845.

[11] The Court's holding aligns with the focus of the Justices' questions at oral argument. Many of the Justices' questions focused less on whether the SEC lacked any authority to obtain disgorgement and more on the issue of whether disgorgement should be limited to net profits and returned to victims. Oral Argument Transcript at 8:3-11, 9:23-10:8, 8:12-11:21, 34:3-20, 36:11-13, 40:2-5, *Liu*, No. 18-1501 (U.S. Mar. 3, 2020)

[12] *Id.* at *7.

[13] *Id.* at *8-9.

[14] *Id.*

[15] *Id.* at *9.

[16] *Id.*

[17] *Id.*

[18] *Id.* at *10.

[19] *Id.*

[20] *Id.* at *10 n.5.

[21] *Id.* at *11.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.* at *12.

[28] *Id.*

[29] *Id.* at *12.

[30] *Liu*, 2020 WL 3405845, at *11.

[31] *Id.* at *11.

[32] *Id.*

[33] *Id.*