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One Step Forward, Two Steps Back for the SEC? U.S. Supreme Court Decision on SEC's Disgorgement Authority Raises More Questions Than It Answers

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The U.S. Supreme Court handed down its long anticipated decision in *Liu v. Securities and Exchange Commission*[1] ("*Liu*") on Monday June 22, 2020, answering a question the Court itself had posed in its 2017 *Kokesh v. SEC* decision[2]—whether the Securities and Exchange Commission ("SEC") had authority to seek disgorgement from defendants in a federal action. In an 8-1 decision, the Court held that the SEC does have statutory authority to seek disgorgement as equitable relief. However, that authority is not without limitations, and the decision raises a number of questions regarding the application of that authority.

To qualify as an equitable remedy available to the SEC, the Court also held that the amounts subject to disgorgement must be limited to the defendant's net profits and awarded for the benefit of victims. The decision specifically noted the "considerable tension" between the SEC's equitable authority as authorized in 15 U.S.C. §78u(d)(5), and the SEC's (and courts') customary practice of (1) ordering disgorged funds deposited in the U.S. Treasury rather than disbursing them to victims, (2) declining to reduce the amounts by the legitimate business expenses incurred associated with the activity, and (3) imposing liability on a joint-and-several basis.[3]

While a nominal victory for the SEC—the Court upheld its authority to seek disgorgement as a remedy—the Court remanded the case to the lower courts to determine whether the disgorgement award in *Liu* was consistent with the equitable principles outlined in the decision. As a result, the decision raises many questions for ongoing and future SEC enforcement cases, including:

- Whether the SEC will be able to continue to secure the large monetary settlements in federal court actions it has achieved in recent years, such as in Foreign Corrupt Practices Act ("FCPA") and other international corruption- and fraud-related cases under the disgorgement banner without (1) deducting significant legitimate expenses from the disgorgement amounts or (2) identifying and distributing to harmed investors or other ostensible "victims" such as foreign sovereigns or state-owned enterprises;

- Whether disgorgement will be available where there are no identifiable victims at all, such as in certain insider trading and other cases; and
- Whether the SEC will be more circumspect when negotiating resolutions with cooperating companies and individuals, now that there are clear binding principles for how disgorgement should be calculated in SEC actions filed in federal court.

At the very least, we view *Liu* as one step forward and two steps back for the SEC. On the one hand, the SEC's authority to seek disgorgement is secure. On the other, the decision clarifies limitations on that authority and essentially forces the SEC into a situation where it will continue to have to litigate the parameters of the decision in *Liu* until a final set of precedents are established. We also expect the SEC to seek to resolve more of its cases through its administrative process—Monday's ruling applies only to disgorgement sought in the federal courts—and be forced to litigate whether the principles established in *Liu* apply to actions resolved through the administrative process as well.

The Underlying Dispute

In 2017, the Court found in *Kokesh* that the SEC's disgorgement remedy is a "penalty" for the purposes of 28 U.S.C. §2462, bringing it within the federal catch-all five-year statute of limitations. The Court's conclusion in *Kokesh* was based on several factors, including that the remedy imposed by the SEC was done so for violating public laws, was partly imposed for punitive purposes, and was not compensatory in nature.[4] While important at the time, the Court specifically cautioned in *Kokesh* that its decision should *not* be interpreted as whether courts possess the authority to order disgorgement under 15 U.S.C. §78u(d)(5).

Relying on *Kokesh*, Petitioners Charles Liu and Xin Wang nevertheless sought to have the disgorgement order in their case voided on the grounds that the SEC had no statutory authority to seek disgorgement in federal court actions whatsoever. The couple had solicited funds from overseas investors to construct a cancer treatment center. The SEC filed a civil action against them both, alleging that funds were misappropriated and seeking disgorgement of the full amount raised from investors, less the amount remaining in a corporate bank account. The District Court issued an award for more than $26 million in disgorgement, enforceable jointly and severally against Liu and Wang.

Liu and Wang argued that the disgorgement was necessarily a penalty, and as result not included in the SEC's authority to seek equitable relief under 15 U.S.C. §78u(d)(5). Liu and Wang also argued that the District Court did not conform the award to traditional equity practice by refusing to deduct legitimate business expenses, failing to return funds to the victims, and improperly holding them jointly and severally liable for the full amount of the disgorgement award.

In its decision reviewing the District Court's disgorgement order, the Supreme Court observed that because "Congress did not define what falls under the umbrella of 'equitable relief' . . ." it fell to the Court to consider "which remedies the SEC may impose as part of its §78u(d)(5) powers."[5] To answer that question, the Court "analyze[d] whether a particular remedy [fell] into 'those categories of relief that were typically available in equity.'"[6] The Court held that while equity practice has always allowed courts to strip wrongdoers of ill-gotten gains, courts nevertheless must restrict the practice to prevent it from turning into a penalty, which has historically been done by requiring relief to be returned to victims, granting awards based on each individual's ill-gotten gains, and restricting the amount of the equitable relief to net profits rather than gross profits or gross receipts.

The case was remanded to the Ninth Circuit to consider whether, notwithstanding the fact that the underlying disgorgement order had been calculated on a gross-profit basis jointly and severally, and the funds would only be remitted to the U.S. Treasury and not victims, the disgorgement sought nevertheless might be consistent with the SEC's statutory authority as set out in its decision.

Implications Going Forward

Monday's ruling made clear that the disgorgement remedy is available to the SEC under its existing statutory authority. While perhaps not surprising to those who have followed this issue through the courts, such a ruling is nevertheless significant and raises a number of questions for the SEC that remain unanswered, with the restrictions the Court placed on the disgorgement remedy having the potential to change the SEC's enforcement approach in meaningful ways.

1. *A Different Approach Required?* If "disgorgement" must be remitted to investors or other victims to qualify as disgorgement at all, it may be that the large federal-court administered settlements the SEC has secured over the past 15 years in Foreign Corrupt Practices Act ("FCPA") and other international corruption and fraud cases, where the "disgorged" funds are remitted to the U.S. Treasury, are no longer available to the SEC—or at least will need to be pursued through other avenues. While it is possible in some cases to imagine the SEC finding an acceptable avenue to pay over disgorged funds to harmed investors in a case like the underlying *Liu* enforcement action, it is difficult to see how the SEC would remit payments in large FCPA cases to the governments of countries which nominally could be considered "victims" of corruption. Officials of such countries and/or their state-owned enterprises may themselves be involved in the underlying corruption scheme, not be parties to whom the SEC would remit compensatory or restitutionary funds, or simply not be identifiable. It is even less clear how the courts will address cases in which there are no readily identifiable victims at all, such as many insider trading cases.

2. *More Discipline in Negotiations?* Under *Liu*, it is clear that SEC disgorgement must be calculated net of legitimate business expenses. While the courts will have to develop the rules of the road through actual litigated cases, it remains to be seen whether the SEC will temper its more aggressive requests for "disgorgement" in ongoing and future resolution negotiations—and whether companies will be willing to litigate their matters against the SEC in the face of disgorgement demands that do not faithfully apply the principles set out in *Liu*. Interestingly, while the Supreme Court in *Liu* did not conduct detailed analysis in this respect, it did note that certain expenses, like lease payments and the purchase of equipment, in line with the lawful purpose of the business "have value independent of fueling a fraudulent scheme" and may be deductible in a net profit calculation.[7]

   As the deduction of even these kinds of indirect overhead-type expenses has been denied by the SEC in the past, it will be interesting to see whether this holding changes the SEC's approach. As the Court explicitly noted, the federal district courts will be tasked with working out the principles as to what types of expenses will be deductible from a net profit calculation and which will not.

3. *Joint and Several Liability*? Courts will also need to define those circumstances in which the common law will allow for defendants to be held liable for disgorgement on a joint-and-several basis, and those in which the traditional rule prohibiting disgorgement on that basis will apply.

As we noted above, we believe that one of the likely outcomes of *Liu* will be the increasing attractiveness of using the SEC's administrative process to resolve ongoing investigations going forward, allowing the SEC to take the position that *Liu* does not apply in that context. Along with the other open questions discussed here, that question is sure to be litigated, ensuring that the SEC will continue to need to defend and define its disgorgement authority for years to come.

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[1] No. 18-1501 (U.S. June 22, 2020).

[2] *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

[3] *Liu*, No. 18-1501, slip op. at 12.

[4] *Kokesh*, 137 S. Ct. at 1643-44.

[5] *Liu*, No. 18-1501, slip op. at 2.

[6] *Id.* at 5 (quoting *Mertens v. Hewitt Associates*, 508 U. S. 248, 256 (1993)).

[7] *Liu*, No. 18-1501, slip op. at 19.