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PERSPECTIVE

Opinion invites future battles on limits of SEC disgorgement

By Thomas Zaccaro,
Nicolas Morgan, Kyle Jones
and Michael Mottweiler

On Monday, Justice Sonia Sotomayor, writing for an eight-justice majority in *Liu v. SEC*, 2020 DJDAR 6054, addressed several unanswered questions from the U.S. Supreme Court's unanimous 2017 decision in *Kokesh v. SEC*, 2017 DJDAR 5301: i.e., whether (i) "courts possess authority to order disgorgement in SEC enforcement proceedings" and (ii) "courts have properly applied disgorgement principles in this context." Although the Supreme Court determined that courts possess the requisite authority to order disgorgement, *Liu* is hardly a win for the Securities and Exchange Commission. Justice Sotomayor identified several limitations courts must follow when ordering disgorgement that call into

question the SEC's current unfettered use of this remedy and will result in fundamental changes to long-standing SEC practices. The *Liu* opinion is likely only the beginning of the SEC's challenges on this front, as it leaves unanswered thorny questions about how courts should apply these limitations. This vacuum represents a unique opportunity not only to push back against the SEC's current remedies paradigm, but to cement this success with a new round of circuit court decisions interpreting the Supreme Court's criticism of the SEC's application of its disgorgement remedy in *Liu* and *Kokesh*.

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The holding in *Liu* is deceptively straightforward: "[A] disgorgement award that does not exceed a wrong-

doer's net profits and is awarded for victims is equitable relief permissible under [15 U.S.C. Section] 78u(d) (5)." Although the court reserved judgment on whether the disgorgement award in *Liu* itself ran afoul of this holding, Justice Sotomayor provided three limitations on disgorgement for future courts to consider:

- Disgorgement must be awarded to victims, not to the U.S. Treasury.
- Disgorgement may be sought only against a culpable actor, thereby proscribing joint-and-several liability.
- Disgorgement may not exceed a wrongdoer's net profits, allowing wrongdoers to deduct reasonable expenses.

These limitations constitute a clear, if understated, rebuke of the SEC's current disgorgement practices, as the court politely makes clear in writing that "the SEC's disgorgement in such incarnations is in considerable tension

with equity practices." Nevertheless, the Supreme Court recognizes, without ruling one way or the other, each of these limitations still leaves room for interpretation:

- Disgorgement to victims may prove sufficiently impracticable to justify depositing disgorgement proceeds with the Treasury.
- Disgorgement may be sought against multiple defendants "engaged in concerted wrongdoing."
- "Inequitable deductions" may not be allowed if "the entire profit of a business or undertaking" derives from the misconduct giving rise to the disgorgement order. The majority signaled that "extraordinary salaries" and "unconscionable claims for personal

services" are unlikely to constitute legitimate expenses.

Justice Clarence Thomas, the lone dissenter, criticized the majority for expanding the remedies available in SEC enforcement actions beyond the intent of Congress and failing to provide clear guidance to the lower courts on how to implement its decision. Justice Thomas, focusing on the relief available in the English Court of Chancery at the time of the founding of the United States, concludes that "disgorgement is not a traditional equitable remedy" that a court may order pursuant to Section 78u(d)(5). In an attempt to prevent further judicial drift as lower courts interpret the majority's opinion, Justice Thomas advocates adopting clear-cut rules that will ensure disgorgement (however defined) comports with the "traditional rules of equity" by: (i) specifically limiting disgorgement to each wrongdoer's profits; (ii) prohibiting the joint-and-several imposition of disgorgement; and (iii) using disgorged monies to compensate the wrongdoer's victims.

The *Liu* decision answers one big question — whether federal courts may order disgorgement in SEC enforcement actions — but creates many new questions in its wake. Insider trading, for example, presents unique difficulties for the SEC to identify direct harm to particular victims. Indeed, some commentators have argued that insider trading is a crime without specific victims which, if proved correct, could foreclose disgorgement entirely for insider trading. Without an identifiable victim to compensate, would courts be permitted to award disgorgement to the SEC in insider trading cases? Similarly, enforcement actions related to violations of the Foreign Corrupt Practices Act raise similar questions about whether disgorgement may be applied to violations without clearly identifiable victims.

The court's restriction on "collective liability" for disgorgement raises even more questions. For example, the

majority noted that existing precedent on tipper-tippee liability (which allows a tipper to be liable for a tippee's illegal profits) may not comport with the equitable remedies allowed under Section 78u(d)(5). Of course, the SEC also uses joint-and-several liability in other types of cases and will need to defend its practices in these areas as well, particularly when it seeks "collective liability" against individuals with varying levels of culpability. In addition, expenses claimed by alleged wrongdoers present an obvious battleground for both sides. Income taxes in particular stand out as a flashpoint for conflict. Taxes paid on allegedly ill-gotten gains are an unavoidable, legally mandated expense, and therefore not an "extraordinary salary" or "unconscionable claim[] for personal services." The high value of this expense, however, may cause the SEC to resist deductions from disgorgement for income taxes despite this position's obvious tension with *Liu*.

With *Kokesh* and *Liu*, the Supreme Court has helped to keep the SEC honest in seeking disgorgement. By reducing the threat of monumental disgorgement figures, the SEC will be less able to strong-arm one-sided settlements and defendants will be incentivized to present their cases in full before succumbing to the SEC's unreasonable disgorgement demands. ■

Thomas Zaccaro is a partner in Paul Hastings LLP's Litigation Department. He served as regional trial counsel in the SEC's Los Angeles office.

Nicolas Morgan is a partner in Paul Hastings LLP's Litigation Department. He served as senior trial counsel in the SEC's Los Angeles office.

Kyle Jones is an associate in Paul Hastings LLP's Los Angeles office.

Michael Mottweiler is an associate in Paul Hastings LLP's Los Angeles office.