SULLIVAN & CROMWELL LLP

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# *Liu* v. *SEC* – Supreme Court Upholds (but Limits) SEC's Authority to Seek Disgorgement in Civil Enforcement Actions

## The U.S. Supreme Court Holds That Disgorgement Is "Equitable Relief" the SEC May Seek in Civil Actions, but Curtails Its Scope.

### SUMMARY

On June 22, 2020, the U.S. Supreme Court, in an 8-1 decision, held that the Securities and Exchange Commission's authority under 15 U.S.C. § 78u(d)(5) to seek "equitable relief" in addition to monetary penalties includes the authority to seek disgorgement awards in civil enforcement actions, resolving a question left open in the Supreme Court's 2017 decision in *Kokesh* v. *SEC*. The Court noted, however, that prior SEC disgorgement awards had at times exceeded the permissible bounds of that remedy, and instructed that SEC disgorgement may "not exceed a wrongdoer's net profits and is awarded for victims." The Court remanded for the lower courts to consider in the first instance how to calculate the disgorgement award, and provided general guidance. Depending on how these requirements are interpreted going forward, *Liu* may serve as a restraint on the SEC's ability to obtain the same level of disgorgement awards as it has in recent years.

### BACKGROUND

In 15 U.S.C. § 78u(d)(5), Congress authorized the SEC to obtain "any equitable relief that may be appropriate or necessary for the benefit of investors" in civil enforcement proceedings in federal court.[1] Citing this provision, the SEC has long "urged courts to order disgorgement as an exercise of their inherent equity power to grant relief ancillary to an injunction."[2] For decades, courts allowed the SEC to obtain disgorgement in enforcement actions "in order to deprive…defendants of their profits in order to remove any monetary reward for violating securities laws and to protect the investing public by providing an effective deterrent to future violations."[3] Over time, the bounds of the SEC's disgorgement remedy expanded to "test the bounds of equity practice," and courts allowed the SEC to obtain disgorgement remedies when the proceeds of the fraud were to be deposited in Treasury funds rather than returning them to harmed investors, to impose joint-and-several disgorgement liability, and to refuse to allow the deduction of legitimate expenses from the fraud proceeds.[4]

In its 2017 decision in *Kokesh* v. *SEC*, the U.S. Supreme Court cast some doubt on the SEC's disgorgement remedy when it held that SEC disgorgement is a "penalty" for purposes of the five-year statute of limitations in 28 U.S.C. § 2462, as "equitable relief" historically excluded punitive sanctions.[5] In reaching this conclusion, the *Kokesh* Court reasoned that disgorgement "bears all the hallmarks of a penalty: [i]t is imposed as a consequence of violating a public law and it is intended to deter, not to compensate."[6] During the *Kokesh* oral argument, several Justices openly questioned whether the SEC had statutory authority to obtain disgorgement at all.[7] But the Court ultimately held open the question of "whether courts possess authority to order disgorgement in SEC enforcement proceedings or whether courts have properly applied disgorgement principles in this context."[8]

Three years later, that question returned to the Court in *Liu* v. *SEC*.[9] The petitioners in *Liu* are a married couple who solicited nearly $27 million from foreign investors under an immigration program allowing foreign investors to apply for permanent U.S. residence based on investments in approved commercial enterprises. The SEC brought this enforcement action alleging that, rather than putting the money they had raised toward the construction costs of a cancer-treatment center as pledged in the relevant offering memorandum, the petitioners had misappropriated millions of dollars. The District Court granted an injunction barring petitioners from participating in the immigration program, imposed an $8.2 million civil penalty, and ordered disgorgement of $26,733,018.81,[10] which was "equal to the full amount petitioners had raised from investors, less the $234,899 that remained in the corporate accounts for the project."[11] The Ninth Circuit affirmed.

In their petition for certiorari, the petitioners argued that the reasoning in *Kokesh* prohibited courts altogether from awarding disgorgement as "equitable relief" under 15 U.S.C. § 78u(d)(5). On November 1, 2019, the Supreme Court granted certiorari to resolve that question.

## THE COURT'S DECISION

In an 8-1 decision authored by Justice Sotomayor (Justice Thomas dissented), the Court upheld the SEC's authority to seek "disgorgement" in civil enforcement actions, so long as that remedy met certain requirements. In particular, 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 15 U.S.C. § 78u(d)(5)."[12]

Because Congress had not specifically defined what constitutes "equitable relief" under 15 U.S.C. § 78u(d)(5), the Court looked to the "categories of relief that were *typically* available in equity'" to determine whether disgorgement fell under that statutory term.[13] Surveying historical authority, the Court concluded that, although the specific label for disgorgement-type relief had varied over time, equitable powers have long included the ability of courts to "strip wrongdoers of their ill-gotten gains."[14] The Court rejected petitioners' argument that equity courts limited the disgorgement remedy to cases involving a breach of trust or fiduciary duty, noting as an example that a profits-based remedy had been "habitually awarded" in patent cases long before Congress authorized an "accounting" remedy in 1870.[15]

The Court explained, however, that, "to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims." Specifically, the Court explained that historical equity courts had limited this remedy by: (i) often imposing a "constructive trust" on the wrongful gains for wronged victims; (ii) generally only awarding a profits-based remedy against individuals or partners engaged in concerted wrongdoing, eschewing joint-and-several disgorgement liability; and (iii) limiting awards to the net profits from wrongdoing and allowing the deduction of "legitimate expenses."[16] In light of these limits established by equity courts, which the Court presumes Congress intends to incorporate when it uses the term "equitable relief" in statutes, the Court rejected the government's contention that the SEC's broader interpretation of disgorgement—which enlarged the traditional bounds of the equitable profit-based remedy—had been tacitly ratified by Congress through its enactment of other statutes referring to "disgorgement."[17]

Because the parties had focused their briefing on whether the SEC was permitted to seek disgorgement at all, rather than the particular amount of disgorgement permissible under the Court's opinion, the Court vacated the Ninth Circuit's decision and remanded for the lower courts to consider the amount of a permissible disgorgement award here. The Court outlined three principles to guide lower courts' assessment of that question.

First, the Court highlighted that § 78u(d)(5) restricts equitable relief to that which "may be appropriate or necessary for the benefit of investors," although the SEC has sometimes deposited a portion of disgorged funds in the Treasury rather than returning them to harmed investors.[18] The Court explained that "the equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for its benefit."[19] The Court rejected the government's contention that the mere fact that the SEC conducted an enforcement action satisfies the "for the benefit of investors" requirement of § 78u(d)(5); to the contrary, the Court held that disgorgement "must do more than simply benefit the public at large."[20] The Court then left it as an "open question" for lower courts to decide whether the SEC's practice of depositing disgorgement funds with the Treasury when it is infeasible to distribute the funds to victimized investors is consistent with the "for the benefit of investors" requirement.[21]

Second, the Court noted that the practice of imposing joint-and-several disgorgement liability on a wrongdoer for benefits that accrue to other actors or affiliates "could transform any equitable profits-focused remedy into a penalty."[22] But the Court observed that the historical disgorgement remedy did allow "some flexibility to impose collective liability"—for instance, in the case of a partnership between wrongdoers. But the Court stated that it "need not wade into all the circumstances where an equitable profits remedy might be punitive when applied to multiple individuals," and left the determination to the lower courts in the first instance.[23]

Third, the Court held that "courts must deduct legitimate expenses before ordering disgorgement under § 78u(d)(5)," unless those expenses are incurred as part of an entirely fraudulent scheme.[24] Thus, lower courts must determine whether expenses are legitimate or whether they are "merely wrongful gains 'under another name.'"[25] The Court noted that some of the expenses from petitioners' scheme were used for lease payments and cancer-treatment equipment, and remarked that "[s]uch items arguably have value independent of fueling a fraudulent scheme," but once again left the determination of which expenses to include in a disgorgement remedy to the lower courts.[26]

Justice Thomas dissented, arguing that "disgorgement can never be awarded under 15 U.S.C. § 78u(d)(5)" because, in his view, "disgorgement" was not recognized as an equitable remedy in the English Court of Chancery at the time of the founding of the United States.[27] Justice Thomas noted that the Court's decision left open many questions regarding the scope of this remedy, including that it was unclear whether the Court's restrictions on the disgorgement remedy in the judicial context would also apply in administrative proceedings, in which the SEC is expressly authorized to seek disgorgement.[28]

## IMPLICATIONS

On the one hand, the Supreme Court's decision resolves that the SEC *does* have the authority to obtain disgorgement as an equitable remedy in civil enforcement proceedings. But by limiting that remedy to awards that do "not exceed a wrongdoer's net profits" and are "awarded for victims,"[29] the decision imposes potentially significant constraints on the SEC's ability to obtain large disgorgement awards.

These limitations may prove meaningful. The SEC has relied heavily on disgorgement as part of its civil-enforcement paradigm. In its 2019 fiscal year, for example, the SEC obtained approximately $3.2 billion in disgorgement and $1.1 billion in penalties.[30] Further, the SEC historically has not returned all disgorged monies to investors. In FY 2019, for example, the SEC returned only $1.2 billion (of $3.2 billion in disgorged funds) to investors.[31] In *Liu*, the Court left open whether the SEC's practice of depositing disgorged funds with the Treasury is permissible when the SEC maintains that it is infeasible to distribute disgorged funds to investors. If courts ultimately require the remittance of funds to harmed investors in order for disgorgement to be permissible, the SEC's ability obtain large disgorgement awards may be limited. This may prove especially relevant in the FCPA context where identifying harmed investors could prove particularly difficult and where the putative victims of the corruption are typically countries ruled by government officials who were complicit in the corruption.

As a practical matter, the Supreme Court's decision also leaves open how courts should determine which "legitimate expenses" must be deducted from a disgorgement award. The Court implied that some of the petitioners' payments in *Liu* were legitimate expenses, but noted that "it is not necessary to set forth more guidance addressing the various circumstances where a defendant's expenses might be considered wholly fraudulent."[32] It thus now falls to the lower courts to determine which party bears the burden of proof to show which business expenses are legitimate and thus must be excluded from a disgorgement award, as well as to determine what types of business expenses are legitimate. For example, again in the FCPA context, defendants may be able to argue that any disgorgement award should be reduced by the cost of performing under a contract that was obtained by bribery, on the theory that the contract has some value independent of the bribery scheme.

Courts, including within the Second Circuit, have typically required the SEC to demonstrate only that a disgorgement request is "a reasonable approximation of the profits causally related to the wrongdoing," and then shifted the burden to the defendant to demonstrate that some portion of its revenue from an unlawful transaction comprised legitimate expenses and thus should be excluded from the award.[33] It remains to be seen whether *Liu* will affect that framework or result in deduction of different or broader expense categories than courts have previously been willing to exclude from disgorgement calculations.

The Supreme Court's decision also leaves open, as Justice Thomas's dissent pointed out, whether the limits that the Court placed on disgorgement within the 15 U.S.C. § 78u(d)(5) context will also apply when the SEC seeks disgorgement as part of administrative proceedings as authorized by 15 U.S.C. § 77h-1(e).

In addition, *Liu* may impact the ability of other federal agencies—including the Federal Trade Commission (FTC), the Commodity Futures Trading Commission, and the Consumer Finance Protection Bureau among others—to seek disgorgement-like remedies where those agencies lack explicit statutory authorization. For example, the Supreme Court is currently considering a petition for certiorari filed by the FTC in *FTC* v. *Credit Bureau Center*, in which the FTC seeks reversal of a Seventh Circuit decision holding that federal courts cannot award restitution under a similar (but arguably narrower) statutory provision in Section 13(b) of the FTC Act.[34]

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## ENDNOTES

1 In November 2019, in a bipartisan vote of 314-95, the House of Representatives passed the Investor Protection and Capital Markets Fairness Act, which would amend 15 U.S.C. § 78u(d) to explicitly authorize the SEC to obtain disgorgement in civil enforcement proceedings. *See* H.R. 4344 (as passed by House November 18, 2019). The bill is currently before the Senate Committee on Banking, Housing and Urban Affairs.

2 *Kokesh* v. *SEC*, 137 S. Ct. 1635, 1640 (2017) (quoting *SEC* v. *Tex. Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (S.D.N.Y.1970), *aff'd in part, rev'd in part*, 446 F.2d 1301 (2d Cir. 1971)).

3 *Id.*

4 *Liu* v. *SEC*, 591 U.S. __, 12 (2020).

5 *Kokesh*, 137 S. Ct. at 1644; *Liu*, 591 U.S. __ at 1.

6 *Id.*

7 S*ee, e.g.*, Tr. of Oral Argument at 31:16-21 137 S. Ct. 1635 (2017) (No. 16-529) (Chief Justice Roberts: "One reason we have this problem is that the SEC devised this remedy or relied on this remedy without any support from Congress."); *id.* at 7:20-8:2 (Justice Kennedy: "Is it clear that the district court has statutory authority to do this? . . . Is—is there specific statutory authority that makes it clear that the district court can entertain this remedy?").

8 *Kokesh*, 137 S. Ct. at 1642-44 n.3.

9 *Liu*, 591 U.S. __ at 3.

10 *SEC* v. *Liu*, 262 F. Supp.3d 957, 975-76 (C.D. Cal. 2017), *vacated*, 591 U.S. __ (2020).

11 *Liu*, 591 U.S. __, 5 (2020).

12 *Id.* at 1.

13 *Id.* at 5 (quoting *Mertens* v. *Hewitt Assocs.*, 508 U.S. 248, 26 (1993)).

14 *Id.* at 6–9.

15 *Id.* at 8.

16 *Id.* at 9–11.

17 *Id.* at 13–14.

18 *Id.* at 14.

19 *Id.* at 15.

20 *Id.* at 16.

21 *Id.* at 16–17.

22 *Id.* at 17.

23 *Id.* at 18.

24 *Id.* at 19.

25 *Id.* (quoting *Rubber Co.* v. G*oodyear*, 76 U.S. 788, 803 (1869)).

26 *Id.* at 19.

27 *Id.* dissent at 1 (Thomas, J., dissenting).

**ENDNOTES (CONTINUED)**

28 *Id.* dissent at 7–8; *see* 15 U.S.C. § 77h-1(e) ("In any cease-and-desist proceedings . . . the Commission may enter an order requiring accounting and disgorgement, including reasonable interest.")

29 *Liu*, 591 U.S. at 1.

30 *See* SEC Division of Enforcement, *2019 Annual Report*, 16–17 (2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

31 *Id.*

32 *Liu*, 591 U.S. __ at 19.

33 *SEC* v. *Rosenfeld*, 2001 WL 118612, at *2 (S.D.N.Y. Jan. 9, 2001).

34 *Compare* 15 U.S.C. § 53(b) ("Whenever the Commission has reason to believe . . . that any person, partnership, or corporation is violating, or is about to violate, any provision of law enforced by the Federal Trade Commission, and . . . the enjoining thereof pending the issuance of a complaint by the Commission and until such complaint is dismissed by the Commission or set aside by the court on review, or until the order of the Commission made thereon has become final, would be in the interest of the public . . . *the Commission by any of its attorneys designated by it for such purpose may bring suit in a district court of the United States to enjoin any such act or practice*. . . in proper cases the Commission may seek, and after proper proof, the court may issue, a permanent injunction.") (emphasis added) *with* 15 U.S.C. § 78u(d) ("Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter . . . it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices.")

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