ALERTS

Supreme Court Limits Disgorgement in SEC Enforcement Actions

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On June 22, 2020, in *Liu v. SEC*, the U.S. Supreme Court limited the SEC's authority to seek disgorgement in enforcement actions in federal court, holding that the amount cannot exceed a defendant's net profits and generally must be used to repay harmed investors.

The SEC brought a civil enforcement action against defendants who allegedly misappropriated much of the money they raised from foreign investors towards the construction of a cancer center in the United States, contrary to their statements in an offering memorandum.[1] The District Court ruled in the SEC's favor and imposed disgorgement, jointly and severally, of the full amount the defendants had raised.[2] The Ninth Circuit affirmed.[3]

Justice Sotomayor delivered the opinion of a nearly unanimous Court.[4] The Supreme Court held that the SEC can properly pursue disgorgement in federal court, but limited the manner in which the amount of that remedy is calculated and distributed.

Previously, in its 2017 decision in *Kokesh v. SEC*, the Supreme Court held that disgorgement is a "penalty," in the context of determining the statute of limitations.[5] There, the Court left open the question of whether "courts possess authority to order disgorgement in SEC enforcement proceedings."[6]

The defendants invited the Court to answer that question "no." The defendants argued that *Kokesh* effectively held that disgorgement is necessarily punitive and therefore is not part of the "equitable relief" the

SEC is permitted to seek in federal court enforcement actions.[7] The Supreme Court rejected this argument, noting that historically, courts had long been authorized under equitable principles to deprive wrongdoers of their unlawful profits so the money could be returned to victims.[8]

At the same time, in order to avoid transforming disgorgement into a penalty outside the courts' equitable powers, the Supreme Court placed significant limits on the SEC's authority to seek disgorgement.

First, the Court held that the calculation must deduct legitimate expenses.[9] Only the wrongdoer's net profits are the proper subject of disgorgement, to avoid the remedy becoming a punishment.[10] For example, the Court suggested that the amounts the *Liu* defendants spent towards lease payments and actual cancer-treating equipment were likely eligible for deduction, and instructed the lower courts to consider whether to deduct them.[11] The opinion noted, however, that a defendant may be denied deductions where the "entire profit of a business or undertaking" results from the wrongdoing.[12]

Second, the Court held that the SEC had gone too far in seeking disgorgement for profits that did not accrue to the defendant individually.[13] The Court recounted the long history of equity jurisprudence that disallowed joint and several liability and required individual liability for wrongful profits unless the defendants were "partners engaged in concerted wrongdoing."[14] The opinion casts doubt on prior decisions, like the Second Circuit's decision in *SEC v. Contorinis*, that required the defendant to pay back not only his own gains but also benefits that he never touched, which his close associates enjoyed because of his wrongdoing.[15] Here, the Court left for remand whether the defendants, who were married and solicited investments together, had the type of partnership that would allow joint and several liability.[16]

Third, the Court held that the equitable nature of disgorgement generally requires the SEC to return a defendant's ill-gotten gains to the wronged investors.[17] The Court rejected the SEC's view that simply depriving wrongdoers of ill-gotten gains was a permissible equitable remedy that would enable the SEC to deposit disgorged funds into the Treasury indefinitely.[18] After all, the Court reasoned, the statute does not allow "equitable relief" at large, but only the equitable relief that is "appropriate and necessary for the benefit of investors."[19] The Court hinted a different rule might apply in a situation where the "profits cannot

practically be disbursed to the victims" but did not reach that question in this case.[20]

The *Liu* ruling will fundamentally reshape the amount the SEC can obtain as disgorgement in enforcement actions and, potentially, administrative proceedings.[21] While the Court did not eliminate the SEC's authority to seek disgorgement altogether, this opinion will serve to curtail some of the SEC's longstanding disgorgement practices. The ability to deduct expenses when accused of wrongdoing and to focus the remedy on each participant's individual gain will be meaningful to many who face SEC enforcement actions.

Liu's impact on disgorgement in insider trading cases, in particular, will be hotly debated. Under prior law, the SEC regularly sought to disgorge insider trading profits, even those earned by persons other the defendant.[22] Now, defendants can be expected to advance arguments drawing on all three of the limitations announced in *Liu*: that legitimate expenses must be deducted from any disgorgement award; that the defendant cannot be held liable for trading profits earned by others; and that no disgorgement is proper where, as is typically the case, the victims of insider trading are difficult to identify and thus unlikely to receive any award the SEC distributes.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *Liu v. SEC*, No. 18-1501, slip op. at 4 (June 22, 2020).

[2] *Id.* at 5.

[3] *Id.*

[4] Justice Thomas would have held that disgorgement was never available to the SEC in enforcement actions because, in his view, "disgorgement is not a traditional equitable remedy." *Liu v. SEC*, slip op. at 22 (Thomas, J., dissenting).

[5] *Kokesh v. SEC*, 137 S. Ct. 1635, 1644 (2017).

[6] *Id.* at 1642 n.3.

[7] *Liu*, slip op. at 12; *see* 15 U.S.C. § 78u(d)(5) (authorizing the SEC to seek in a federal court enforcement action the "equitable relief that may be appropriate or necessary to protect investors."). The defendants also emphasized that the statute authorizing administrative proceedings before the SEC's own administrative law judges explicitly lists disgorgement as a remedy. 15 U.S.C. § 77h–1(e), (g). The Court readily dispensed with this difference in statutory language, noting that courts have inherent equity powers while administrative agencies have only the powers a statute expressly confers. *Liu*, slip op. at 13.

[8] *Id.* at 8-9, 12-13.

[9] *Id.* at 10-12, 19.

[10] *Id.* at 6-9.

[11] *Id.*

[12] *Id.* at 19.

[13] *Id.* at 17.

[14] *Id.* at 9-10, 18.

[15] *Id.* at 12 n.3, 17 (discussing *SEC v. Contorinis*, 743 F.3d 296, 304-06 (2d Cir. 2014)).

[16] *Id.* at 18.

[17] *Id.* at 15.

[18] *Id.* at 15-16.

[19] *Id.* at 16 (quoting 15 U.S.C. § 78u(d)(5)).

[20] *Id.* at 17.

[21] Justice Thomas' dissenting opinion states that "[i]t is unclear" whether the Court's restrictions on disgorgement will apply in administrative proceedings as well. *Liu v. SEC*, slip op. at 8 (Thomas, J. dissenting).

[22] *See Liu v. SEC*, slip op. at 17 (majority opinion) (quoting *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990) ("It is well settled that a tipper can be required to disgorge his tippee's profits.").

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