# Supreme Court Upholds Limited SEC Right to Obtain Disgorgement in Court Enforcement Proceedings

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In June 2020, the US Supreme Court issued its long-awaited decision in *Liu v. Securities and Exchange Commission*, No. 18-1501, which resolved a cloud over the remedial powers of the Securities and Exchange Commission (SEC) that had been hovering since 2017. In a decision written by Justice Sotomayor for an eight-member majority, the Court held that disgorgement is an available remedy in an SEC enforcement action in federal court under 15 U.S.C. § 78u(d)(5) (Section 78u(d)(5)). This provision of the Securities Exchange Act of 1934 entitles the SEC, in any federal court action for violations of the federal securities laws, to "any equitable relief that may be appropriate or necessary for the benefit of investors."

Although the Supreme Court upheld the SEC's authority to obtain disgorgement as "equitable relief" under Section 78u(d)(5), the Court recognized several limitations on the remedy and left it to the lower courts to define further the contours of those limitations. The Court's open-ended ruling raises issues that likely will bedevil SEC enforcement proceedings for years to come.

## Supreme Court Decision

The *Liu* decision had its origin in a scheme by a husband and wife to defraud foreign nationals using an investment project structured around the federal government's EB-5 Immigrant Investor Program. The program permits non-citizens to apply for permanent residence in the United States by investing in approved projects for promoting economic growth. Sales of investments in the projects are subject to the federal securities laws.

The SEC accused the defendants of employing a false offering memorandum to raise investor funds for a project. It charged that, while some of the funds were spent on project-related tasks, the bulk of the funds (approximately $20 million) were misapplied, including for the defendants' own personal use. The district court agreed with the SEC's allegations and, among other remedies, ordered the defendants to disgorge the full amount they had raised from investors, less a minor sum still held in the defunct project accounts. The US Court of Appeals for the Ninth Circuit affirmed the district court's judgment.

In their appeal to the Supreme Court, the defendants challenged the SEC's right to obtain disgorgement, contending that it did not qualify as "equitable relief" under Section 78u(d)(5). That issue had been percolating since the Court ruled in *Kokesh v. SEC*, 137 S.Ct. 1635 (2017), that a disgorgement order in an SEC enforcement action imposed a "penalty" for purposes of the applicable limitations statute (28 U.S.C. § 2462). Because a penalty historically has been deemed inconsistent with equitable relief, the *Kokesh* decision spawned doubt over whether disgorgement was included within Section 78u(d)(5)'s grant of equitable remedies.

The Supreme Court, however, made short work of the defendants' argument. The Court noted that, in the *Kokesh* decision, it expressly reserved the question of whether courts have authority to order disgorgement in SEC enforcement proceedings. Examining that question directly in *Liu*, the Court found that disgorgement historically has been treated — by commentators and courts, including the Supreme Court itself — as an equitable remedy, on par with such other forms of equitable relief as restitution and an accounting. Consistent with this

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historical treatment, 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 § 78u(d)(5)." (Emphasis supplied.)

The Supreme Court's careful articulation of the hallmarks of a disgorgement award that render it "equitable relief" under Section 78u(d)(5) was no accident. The Court observed that, in various judicial decisions issued over time, the disgorgement remedy had expanded beyond the scope of traditional equitable relief, and rejected the SEC's position that Section 78u(d)(5) authorized such an expansive scope. Instead, the Court identified the following three criteria that serve to cabin a disgorgement award within equity's historical limits and prevent the award from being transformed into a penalty:

- the disgorgement award generally must be limited to the "net profits from wrongdoing after deducting legitimate expenses";
- the amounts ordered as disgorgement generally must be returned to the victims of the wrongdoing; and
- the disgorgement award generally must be entered against "individuals or partners engaged in concerted wrongdoing, not against multiple wrongdoers under a joint-and-several liability theory."

Despite identifying the broad criteria for determining what constitutes an "equitable" disgorgement award, the Supreme Court declined to adopt any bright-line tests. Instead, the Court left it to the Court of Appeals for the Ninth Circuit on remand to determine whether the disgorgement award in *Liu* constituted equitable relief and, more generally, to the lower courts to explore the boundaries of disgorgement awards that would meet the *Liu* standards. The Court did acknowledge some of the issues to be considered, including the following:

*Net Profits*. The restriction of disgorgement awards to a wrongdoer's "net profits" requires courts to determine the "legitimate expenses" incurred by the wrongdoer that must be deducted from an award. Expenses, however, do not always have to be deducted. As the Court noted, where the "'entire profit of a business or undertaking' results from the wrongful activity," no deduction for expenses may be required. Whether the *Liu* defendants had to disgorge all the money raised from investors (as the district court had ordered) or only the portion they misapplied was one of the issues the Court left for decision on remand.

*Payment to Victims*. In addressing the return of disgorged funds to the victims of the misconduct, the Court noted that, as a general matter, a disgorgement award that does not distribute the funds to victims, although benefiting the public at large by depriving wrongdoers of their ill-gotten gains, does not qualify as equitable relief. That rule, the Court noted, raised a question whether the SEC's practice of returning some disgorged funds to victims, while depositing other amounts with the Treasury, would satisfy Section 78u(d)(5) — a substantial issue given that, as the *Liu* defendants argued, the SEC in 2019 reported that it had obtained disgorgement awards for $3.248 billion while returning only $1.2 billion to injured investors. The Court further questioned whether an exception to the requirement might be warranted where the return of funds to investors was not feasible.

*Application to Multiple Wrongdoers*. The Court observed that the limitation of a disgorgement award to those who profit from misconduct, rather than persons who are jointly and severally liable for the misconduct, is not absolute. Rather, an exception exists "for partners engaged in concerted wrongdoing." The Court indicated that the exception might apply in the case of the husband and wife defendants in *Liu*, who appeared to have actively cooperated in pursuing their fraudulent scheme.

## Implications of *Liu*

The implications of the *Liu* decision could be wide-ranging and include, among others, effects

on the structuring of SEC settlements, court consideration of disgorgement orders under other statutes, and the scope of insurance coverage of disgorgement awards.

As is typical with Supreme Court decisions that pronounce broad rules with nuanced exceptions, further litigation can be expected before a dependable set of fact-based guidelines is developed. That process may auger longer proceedings before the SEC and afford more opportunities for the charged parties to negotiate advantageous settlements.

For example, the issue of what constitutes "legitimate expenses" to be deducted from a disgorgement award is likely to spark protracted debate. To the extent that distribution to supposedly injured investors can be negotiated with the SEC as part of a disgorgement award, the distribution could reduce any claim for damages made in a parallel private securities action. Furthermore, there likely will be questions raised over whether a disgorgement remedy is available at all, for example, in the case of "tipper" liability for insider trading where the defendant received no monetary benefit for disclosing insider information.

In addition, the Supreme Court's articulation of the equitable constraints on disgorgement awards under Section 78u(d)(5) may affect courts' consideration of disgorgement orders under other statutes. For example, in administrative proceedings to enforce the federal securities laws, the SEC explicitly is empowered by 15 U.S.C. § 77h-1(e) to order disgorgement. It is possible that courts now will construe that statute's explicit reference to disgorgement as imbued with equity's traditional limitations, as categorized by the Supreme Court in *Liu*, rather than as authorizing a broader form of relief.

The *Liu* decision also may affect disputes with insurers over the coverage of disgorgement awards under particular policy terms. As a general matter, the characterization of a disgorgement award as an equitable remedy rather than a penalty may support an argument that the award should be covered. At the same time, and depending on the particular insurance policy, a disgorgement award may not be considered an insured "loss," consistent with the reasoning in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), in which the court held that disgorgement of wrongfully obtained funds is not a covered loss.

The *Liu* decision brings some clarity to SEC enforcement remedies by affirming the SEC's right to obtain disgorgement awards in federal court actions, while constraining the amount of such awards and the circumstances affecting their issuance. The federal courts now will have to build on *Liu* to define how restrictive the equitable limitations of a disgorgement award must be to support exercise of this remedy.