

Supreme Court Reins In, But Does Not Overturn, SEC's Disgorgement Authority

In a highly anticipated decision, the U.S. Supreme Court on Monday in *Liu v. S.E.C.* No. 18-1501 (2020), took steps to limit the SEC's aggressive use of disgorgement of ill-gotten gains in litigated cases, but did not, as some had hoped, do away with this powerful remedy in litigated actions entirely. Specifically, while leaving lower courts to fill in the precise contours, the Supreme Court articulated three guiding principles for determining the availability and scope of SEC disgorgement: first, disgorgement should benefit "wronged investors" rather than "the public at large"; second, courts may hold parties liable only for their own profits, not others' profits; and

Barry R. Goldsmith is a partner at Gibson, Dunn & Crutcher and co-chair of the firm's securities enforcement practice group. Goldsmith formerly served as executive vice president for Enforcement of the National Association of Securities Dealers, now FINRA. He also served as chief litigation counsel at the SEC where he was responsible for all enforcement litigation brought by the agency. **Frederick R. Yarger** is a partner at the firm, where his practice focuses on complex litigation in trial and appellate courts, including cases involving administrative law and regulatory matters. Previously, Yarger served as Solicitor General for the state of Colorado. **M. Jonathan Seibald** is an associate at the firm.



Barry R. Goldsmith, Frederick R. Yarger and M. Jonathan Seibald of Gibson Dunn & Crutcher (Photo: Courtesy Photo)

third, disgorgement cannot exceed actual gains and must instead be limited to "net profits" after deducting "legitimate expenses."

Since the SEC began obtaining disgorgement over five decades ago, it has become the agency's principal monetary weapon. Indeed, in the most recent fiscal year, the SEC brought in \$1.1 billion in penalties but nearly three times that amount—over \$3.2 billion—in disgorgement. Despite the new limitations the court imposed in *Liu*, disgorgement is likely to remain a key weapon in the SEC's arsenal.

Five Decades of SEC Disgorgement

Courts first granted the SEC authority to obtain disgorgement

in 1970, as a form of implied equitable relief. See *S.E.C. v. Texas Gulf Sulphur*, 312 F. Supp. 77, 93 (S.D.N.Y. 1970). In 1990, SEC enforcers received explicit statutory authority to obtain disgorgement in administrative proceedings, see 15 U.S.C. §77h-1(e), but the authority to seek disgorgement in court remained implied as part of the SEC's ability to seek judicial equitable relief, see 15 U.S.C. §78u(d)(5).

To obtain disgorgement, the SEC must show "a reasonable approximation of profits causally connected to the violation." See *S.E.C. v. Warde*, 151 F.3d 42, 50 (2d Cir. 1998). Once the commission makes this showing, the

burden shifts to the target, who faces the often difficult task of disproving the reasonableness of the SEC's calculation. See, e.g., *S.E.C. v. Whittemore*, 659 F.3d 1, 7 (D.C. Cir. 2011). The target also bears the burden of establishing "legitimate business expenses," which may be deducted from the disgorgement sum, as opposed to expenses paid to support the fraudulent scheme—the proverbial "cost of the getaway car"—which may not. Under this framework, the SEC often has the upper hand—and the numbers prove it. Over the past five years the SEC obtained nearly \$14.5 billion in disgorgement, almost three times what it collected in civil penalties.

Those in the SEC's crosshairs have fought back. In 2017, the agency's adversaries landed a major victory when the Supreme Court barred the SEC from its longstanding practice of seeking disgorgement for aged violations, holding that disgorgement is a "penalty" subject to a five-year statute of limitations. See *Kokesh v. S.E.C.*, 137 S. Ct. 1635 (2017). In doing so, the court explicitly clarified that it was not questioning "whether courts possess authority to order disgorgement in SEC enforcement proceedings." But commentators and lower courts nevertheless began speculating whether the Supreme Court might strike down the remedy in litigated actions altogether.

'Liu' Decision

Liu did not go nearly that far, holding that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is ... permissible under [15 U.S.C.] §78u(d) (5)," the statute authorizing the SEC to seek equitable relief. In preserving the remedy as a general matter, however, the court emphasized its equitable limits, while leaving for future litigation how those limits will play out in practice.

Liu arose from a 2016 enforcement action alleging misappropriation of millions of dollars of investors' funds under the guise of constructing a cancer-treatment center that would have qualified the investors for EB-5 immigration status. The district court agreed with the SEC, ordering, in addition to civil penalties, disgorgement of "all funds received from [the] illegal conduct," which, with prejudgment interest, totaled over \$26 million. *S.E.C. v. Liu*, 262 F. Supp. 3d 957, 975–76 (C.D. Cal. 2017). In calculating disgorgement, the district court did not permit any deduction for business expenses, labeling as "futile" the defendants' argument that the scheme was "at least partially legitimate." The U.S. Court of Appeals for the Ninth Circuit affirmed. See *S.E.C. v. Liu*, 754 Fed. Appx. 505 (9th Cir. 2018).

In holding that SEC disgorgement, properly cabined, constitutes permissible equitable relief, the Supreme Court examined whether the remedy falls within "those categories of relief that were typically available in equity." Based on this analysis, the court found that "courts have occasionally awarded disgorgement in three main ways that test the bounds of equity practice: by ordering the proceeds of fraud to be deposited in Treasury funds instead of disbursing them to victims, imposing joint-and-several disgorgement liability, and declining to deduct even legitimate expenses from the receipts of fraud." But despite identifying these problems, the court did not specifically explain how to resolve them. Instead, it provided general guidelines for lower courts to consult in evaluating disgorgement awards going forward.

First, the court emphasized that disgorgement must be imposed for the benefit of investors, noting that "the SEC's equitable, profits-based remedy must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains." In many cases—for example, where there are no apparent investor victims or it is infeasible to distribute the funds to harmed individuals—the SEC deposits disgorged funds with the Treasury. This practice, the court opined, may be suspect: "It is an open question whether,

and to what extent, that practice ... satisfies the SEC's obligation to award relief 'for the benefit of investors'... ." Whether that practice may continue, however, will be a subject for future litigation.

Next, the court emphasized "the common-law rule requiring individual liability for wrongful profits," while noting that "[t]he historic profits remedy ... allows some flexibility to impose collective liability." Thus, while there could potentially be "liability for partners engaged in concerted wrongdoing," like the married petitioners in *Liu*, joint-and-several liability was "seemingly at odds with the common-law rule."

Finally, the court explained that disgorgement must not exceed a party's ill-gotten gains, and, therefore, "courts must deduct legitimate expenses before ordering disgorgement." The district court in *Liu* "declined to deduct expenses on the theory that they were incurred for the purposes of furthering an entirely fraudulent scheme." Whether all the expenses were illegitimate, however, could not merely be assumed. On remand, the district court will be required to distinguish legitimate, deductible expenses that "have value independent of fueling a fraudulent scheme"—including, potentially, the lease payments and cancer-treatment equipment in *Liu*—from 'inequitable deductions' such as for [the alleged fraudsters'] personal services."

Practical Implications of 'Liu'

While *Liu* will certainly affect SEC enforcement actions going forward, it remains unclear how significantly it will impede the SEC's aggressive use of disgorgement in settled and litigated cases.

In particular, the Supreme Court left open the question of whether, and under what circumstances, the SEC is permitted to deposit disgorged funds into the Treasury where, as is often the case, it is infeasible to distribute funds to injured investors (if any exist). For example, the SEC has leaned on its disgorgement power to obtain large settlements in Foreign Corrupt Practices Act cases where identifying victims or distributing funds would be difficult, if not impossible. In fact, over the last five years, the SEC has returned less than 15% of disgorged funds to harmed investors. The SEC may try to avoid the issue by finding new ways to benefit investors—for example, by depositing disgorgement proceeds into investor protection funds rather than the Treasury—but this issue will be critical in future litigation and settlement negotiations.

Meanwhile, the court's guidance regarding the deductibility of legitimate expenses that "have value independent of fueling a fraudulent scheme" is likely to assist defense counsel in settled and litigated cases, shrinking the

"net profits" eligible for disgorgement. It may also lead to more fact-intensive disgorgement inquiries, perhaps requiring expert analyses on both sides.

Even if *Liu* significantly constrains the SEC's disgorgement authority, the commission could pivot to minimize its impact. First, it is unclear the extent to which *Liu*'s guiding principles apply to SEC disgorgement in administrative proceedings, where there is express statutory authority for the remedy. The SEC may therefore decide to bring more administrative cases and avoid the judicial forum. Additionally, the SEC may increasingly rely on, and aggressively interpret, its statutory authority to pursue civil penalties. As a result, *Liu* may have the effect of altering the mix (but not the amount) of monetary remedies the SEC seeks.

Regardless, it is clear that *Liu*, far from defining the outer boundaries of SEC disgorgement authority, has raised significant questions that will only be resolved through additional litigation. The battle over SEC disgorgement powers is far from over.