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Practice Update

The Supreme Court Curbs Excessive Disgorgement Awards in SEC Civil Enforcement Actions

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On June 22, 2020, the U.S. Supreme Court in *Liu v. Securities and Exchange Commission*, ruled that the U.S. Securities and Exchange Commission (SEC) can seek the remedy of disgorgement in civil enforcement proceedings for securities fraud, provided that the disgorgement award does not exceed a wrongdoer's net profits and any award is used to compensate victims of the securities fraud. This ruling, authored by Justice Sotomayor, is significant because it reins in the SEC and lower courts that have awarded amounts for disgorgement sometimes far exceeding the net profits of securities fraud defendants. However, the Court did not invalidate disgorgement as an SEC remedy, as some had argued should be done.

Background

Under Section 21 of the Securities Exchange Act of 1934 (the Exchange Act), Congress authorized the SEC to enforce securities laws by way of investigating as well as bringing civil proceedings against individuals who have committed securities fraud. Section 21 permits the SEC to obtain civil penalties and "equitable relief" in civil lawsuits, but the statute does not specifically define or delineate the scope of such equitable relief. Instead, federal

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courts have been left to interpret the bounds and limits of equitable relief.

Approximately three years ago, in *Kokesh v. SEC*—another opinion authored by Justice Sotomayor—the Court ruled that disgorgement is a "penalty" within the meaning of a federal statute of limitations and thus must be brought within five years. However, the Court left for another day the question as to whether federal courts have authority to order disgorgement as equitable relief under Section 21(d)(5), given that disgorgement is not specifically listed in Section 21 as an available remedy. That day arrived with the Court's decision in *Liu*, with the Court ruling that disgorgement is a form of equitable relief that can be awarded.

Liu arose out of an alleged scheme to defraud foreign nationals looking to obtain visas through the EB-5 immigrant investor program. The defendants in this case, Charles Liu and his wife, Lisa Wang, raised $27 million from foreign investors that they then fraudulently used on exorbitant expenses and salaries. The SEC brought an enforcement action against the defendants and prevailed, and a federal district court ordered defendants to disgorge the entire amount the defendants had raised from foreign investors less the unspent amounts that remained in corporate accounts for the investment project. The Ninth Circuit affirmed the lower court's decision but did not decide whether the district court had authority to order disgorgement. The Supreme Court then granted certiorari and heard the case.

The Court's Ruling

The Court ruled that disgorgement is an equitable remedy available under Section 21, but the Court clarified that "[c]ourts may not enter disgorgement awards that exceed the gains made upon any business or investment, when both the receipts and payments are taken into the account." Thus, according to the Court, legitimate expenses must be deducted from any amount that is ordered to be disgorged. The Court reasoned that, no matter the label, disgorgement is a longstanding equitable remedy and therefore is contemplated within the types of remedies the SEC may seek in a civil enforcement action. However, the Court clarified that equitable remedies are circumscribed to avoid "transforming [them] into a penalty." The Court explained that equitable disgorgement orders are normally tailored to the specific wrongdoer and amounts equaling the wrongdoer's net profits.

The Court further observed that courts have gone astray from these principles primarily in three circumstances: (1) "by ordering the proceeds of fraud to be deposited in Treasury funds instead of disbursing them to victims," (2) "imposing joint-and-several disgorgement liability," and (3) "declining to deduct even legitimate expenses from the receipts of fraud." In so reasoning, the Court rejected the SEC's position that disgorgement remedies can exceed net profits, explaining that Congress' use of "disgorgement" in other statutes such as in the statutory provisions for SEC administrative enforcement proceedings, "did not expand the contours of [disgorgement] beyond a defendant's net profits—a limit established by longstanding principles of equity."

Though the issue was not before the Court to resolve, the Court addressed and rejected the SEC's position that disgorgement funds may be indefinitely deposited in the U.S. Treasury without being returned to defrauded investors or other victims. The Court acknowledged that it is an open question whether and to what extent the practice of depositing disgorgement funds in the U.S. Treasury is permitted. The Court declined to resolve that issue but advised district courts to "evaluate in the first instance whether that order would indeed be for the benefit of investors."

Finally, the Court expanded on its reasoning that that the SEC cannot impose disgorgement liability on a wrongdoer for benefits that accrue to his or her affiliates, sometimes through joint-and-several liability. The Court reasoned that disgorgement would not be proper if it extended to profits attributable to others for an activity that the defendant completely lacked participation. Disgorgement liability, on the other hand, would be appropriate for "partners engaged in concerted wrongdoing," but the Court declined to draw a clear line between the types of relationship that would make a defendant liable for the wrongful profits of others.

Take-away from the Court's Ruling

Though there are likely many practical consequences that will result from the Court's ruling, three key implications emerge:

1. Federal courts will have to justify disgorgement orders in further detail, providing a better accounting and reasoning for the *amounts* disgorged and *as to each specific defendant*;
2. The SEC will have less power to leverage settlements or cooperation from defendants or co-defendants that potentially face significant disgorgement liability due to a relationship with a clear bad actor who will be required to disgorge significant amounts; and
3. Somewhat conversely, defendants in an SEC civil action can more effectively pressure the SEC or courts to deduct the oftentimes many legitimate expenses that are included in aggressive and overly broad requests for disgorgement.

In the end, while the defendants in this case did not necessarily prevail, the ruling represents a setback to overly aggressive requests from the SEC by requiring it to be more thoughtful about the relief it seeks in a civil enforcement action.

For any more information on this case, securities fraud, or SEC civil enforcement actions, please do not hesitate to contact any member of the Akerman

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