CLIFFORD

CHANCE

U.S. SUPREME COURT RULES SEC MAY SEEK LIMITED DISGORGEMENT AS EQUITABLE REMEDY

On June 22, 2020, the U.S. Supreme Court placed significant limits on the ability of the U.S. Securities and Exchange Commission ("SEC") to maintain its longstanding practice of seeking disgorgement awards as part of an enforcement action for violation of the federal securities laws. In *Liu v. Securities and Exchange Commission*, the Supreme Court held that the SEC may continue to obtain disgorgement awards in civil enforcement actions, as long as those awards do not exceed the defendant's net profits from the violation at issue, and are awarded to victims of the violation.[1] The decision is the latest by the Supreme Court to clarify, and narrow, the scope of the SEC's (once-seemingly broad) power to seek disgorgement awards.

BACKGROUND

There are two ways in which the SEC may pursue enforcement action for violation of the federal securities laws: (1) by bringing a civil enforcement action in federal court; or (2) an administrative action before an administrative law judge ("ALJ"). The SEC has express statutory authority to obtain "disgorgement" as a remedy in an administrative action, but *not* in a civil enforcement action. Rather, Section 21(d)(5) of the Securities Exchange Act of 1934 ("Exchange Act") generally provides that the SEC may seek "equitable relief that may be appropriate or necessary for the benefit of investors."[2] For years, the SEC relied on the "equitable relief" language to obtain large disgorgement awards in civil enforcement actions (or in settlements outside of court), frequently in *addition* to large civil money penalties.

In 2017, the Supreme Court's decision in *Kokesh v. SEC* placed a meaningful restriction on the SEC's ability to seek disgorgement in federal court.[3] There, the

[1] No. 18-1501, 2020 WL 3405845 (June 22, 2020).

[2] 18 U.S.C. § 78u(d)(5). Section 21(d)(5) applies to any civil enforcement action brought by the SEC under "any provision of the securities laws," including the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

[3] 137 S. Ct. 1635 (2017).

Attorney Advertising: Prior results do not guarantee a similar outcome

Court unanimously held that the SEC's disgorgement remedy constituted a "penalty" for purposes of 28 U.S.C. § 2462, and, therefore, was subject to a 5-year statute of limitations. The *Kokesh* Court expressly cautioned that it did *not* address whether courts possess "authority to order disgorgement" in SEC enforcement proceedings in the first place, or whether courts had "properly applied" disgorgement principles in such proceedings. The Supreme Court addressed those issues in *Liu*.

LIU V. SEC

In May 2016, the SEC commenced a civil enforcement action against a husband and wife, alleging that they had defrauded foreign nationals in connection with an Immigrant Investor Program by misappropriating millions of dollars of the solicited investments. The district court granted summary judgment to the SEC.[4] In addition to imposing a civil monetary penalty, the court ordered a disgorgement award holding each defendant jointly-and-severally liable for disgorging the *full amount* the defendants had raised from investors (minus about $200k remaining in the program's accounts). The Court of Appeals for the Ninth Circuit affirmed, holding that the "proper amount of disgorgement in a scheme such as this one is the entire amount raised less the money paid back to the investors."[5] The Supreme Court granted certiorari to determine whether Section 21(d)(5) authorizes the SEC to seek disgorgement beyond a defendant's net profits from the wrongdoing at issue.

THE SUPREME COURT'S RULING IN *LIU*

The Supreme Court ruled that the SEC may, subject to certain restrictions, seek disgorgement as equitable relief. Justice Sonia Sotomayor, writing for the 8-1 majority, held that, to constitute permissible "equitable relief " under Section 21(d)(5), a disgorgement award must "not exceed a wrongdoer’s net profits," and must be "awarded for victims." Thus, the Court vacated the judgment and remanded the case back to the Ninth Circuit.

The Court observed that equity practice had "long authorized courts to strip wrongdoers of their ill-gotten gains"—including, through profits-based remedies such as disgorgement. But the Court noted the distinction between an equitable *profits-based* remedy and a punitive action. The *Liu* Court explained that, to avoid transforming an equitable remedy into a punishment, courts had "restricted" the remedy of disgorgement or restitution "to an individual wrongdoer’s net profits," which were to be returned so they could "be awarded for victims." The Court concluded that Congress, by incorporating "longstanding equitable principles" into Section 21(d)(5), "prohibited the SEC from seeking an equitable remedy in excess of a defendant’s net profits from wrongdoing."

GUIDING PRINCIPLES, OPEN ISSUES, AND IMPLICATIONS MOVING FORWARD

While the *Liu* Court did not rule on Defendants' three "narrower" arguments as to why the disgorgement award was unlawful (*i.e.,* that it fails to return funds to victims, imposes joint-and-several liability, and declines to deduct business

---

4 262 F.Supp.3d 957, 975-76 (C.D. Cal. 2017).
5 754 Fed.Appx. 505 (9th Cir. 2018).

expenses from the award), the Court identified certain "principles" that "may guide the lower courts' assessment of these arguments on remand." The Court's discussion of these guiding principles, however—each tied to what the Court described as the "three main ways" in which prior SEC disgorgement awards had "test[ed] the bounds of equity practice"—left open some significant unresolved questions.

First, *Liu* leaves open the question of whether the SEC must *always* return the *entire* disgorgement award to investors to be sufficiently "for the benefit of" those investors. The Court recognized that "the equitable nature of the profits remedy *generally* requires the SEC to return a defendant's gains to wronged investors for their benefit." But, as the Court acknowledged, the SEC does not always do so. Indeed, in 2019, the SEC returned to investors only $1.2 billion of $4.3 billion in disgorgement and penalties, with the remainder typically deposited with the US Treasury.[6] It thus remains an open question whether—and to what extent—doing so comports with the bounds of equity practice, especially in circumstances where, for example, identifying injured investors might be impracticable or impossible (as may often be the case in insider trading or market manipulation cases).

Second, with respect to multi-defendant cases, the Court did not define the circumstances in which disgorgement could be awarded on a joint-and-several basis (*i.e*., holding each defendant independently liable for the full extent of the injuries caused by all defendants). The *Liu* Court acknowledged that imposing disgorgement liability on a wrongdoer for benefits that accrue to his affiliates "could transform any equitable profits-focused remedy into a penalty." But the Court also acknowledged that joint and several liability could be appropriate in some cases because, historically, the equitable "profits remedy" had "allow[ed] some flexibility to impose collective liability" for "partners engaged in collective wrongdoing." It remains to be seen how lower courts will distinguish circumstances where a disgorgement award applicable to multiple defendants is equitable rather than punitive—especially given what the *Liu* Court described as the "wide spectrum of relationships between participants and beneficiaries of unlawful schemes."

Third, the Court left unresolved how courts should consider business expenses when crafting an equitable disgorgement award based on "net profits." The Court acknowledged that disgorgement awards may properly deny defendants the benefit of "inequitable deductions," including in circumstances where the "*entire* profit of a business or undertaking" resulted from the wrongdoing, or where the expenses are not "legitimate" but rather "merely wrongful gains under another name." But the Court left it to the lower court to examine whether including in a profits-based remedy certain expenses (such as Defendants' lease payments and cancer-treatment equipment, which "arguably have value independent of fueling a fraudulent scheme") would be consistent with Section 21(d)(5)'s equitable principles. As a practical matter, absent additional guidance or narrowing principles, ascertaining "legitimate" expenses within a fraudulent enterprise will be a highly fact-specific inquiry that may, in some instances, come with significant

---

6 *See* SEC Enforcement Division Annual Report, FY 2019 at p.9 (***available at*** https://www.sec.gov/files/enforcement-annual-report-2019.pdf).

challenges—as managers have seen in the SEC's enforcement actions against private funds managers for improper expense allocation.

CONCLUSION

Following on the heels of *Kokesh*, *Liu* is the Supreme Court's latest decision in recent years to limit the SEC's power to seek disgorgement in civil enforcement actions. In practice, the effect of those two decisions is that the SEC may not seek disgorgement of ill-gotten gains older than five years, and disgorgement awards must be returned to investors for their benefit after deduction of "legitimate" business expenses. Moving forward, SEC might face some difficult decisions as to where to bring enforcement actions, balancing the prospects for obtaining maximum disgorgement with other practical considerations such as inability to seek injunctive relief (such as an asset freeze) in administrative proceedings. In civil enforcement actions where disgorgement is denied under *Liu*, parties might still face larger civil money penalties—which the SEC may seek pursuant to its broad statutory authority to do so.[7]

Ultimately, while the *Liu* decision placed important constraints on the SEC's once-seemingly broad ability to seek disgorgement, it left significant unresolved questions regarding how a disgorgement award must be properly tailored and calculated to remain consistent with equitable principles underlying the SEC's statutory enforcement power. We expect that lower courts will continue to grapple with those issues.

[7] 15 U.S.C. § 17(d)(3).

CONTACTS

Robert Rice
Partner

T +1 212 878 8529
E robert.rice@cliffordchance.com

Robert Houck
Partner

T +1 212 878 3224
E robert.houck@cliffordchance.com

John Friel
Partner

T +1 212 878 3386
E john.friel@cliffordchance.com

Steven Gatti
Partner

T +1 202 912 5095
E steven.gatti@cliffordchance.com

Benjamin Berringer
Associate

T +1 212 878 3372
E benjamin.berringer@cliffordchance.com

Minji Reem
Associate

T +1 212 878 8027
E minji.reem@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

© Clifford Chance 2020

Clifford Chance US LLP

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.