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The Supreme Court Affirms, but Limits, the SEC's Disgorgement Power

June 24, 2020

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On June 22, 2020, the Supreme Court of the United States issued its ***decision*** in *Liu v. SEC* further limiting the SEC's remedial powers. While the Court affirmed the SEC's ability to obtain disgorgement for violations of federal securities laws, the decision weakens this historically powerful enforcement remedy, which accounted for more than $3.2 billion in recoveries during the 2019 fiscal year. The Court found that while the SEC may seek disgorgement as an equitable remedy, such awards may not exceed a wrongdoer's net profits and must be awarded for the victims of the violations. The Court also signaled limits to the SEC's ability to hold multiple defendants responsible for the collective profits under "joint-and-several liability." While the Court left a number of issues to be litigated, its decision in *Liu* provides putative SEC defendants with new tools to lower monetary sanctions in SEC settlements and litigation.

The decision stems from an SEC action against Charles Liu and his wife, Xin Wang, for securities violations, alleging that they misappropriated investor funds meant to construct a cancer-treatment center in California. The district court ordered the petitioners to disgorge more than $27 million, the gross amount raised from investors with no deductions for allegedly legitimate business expenses. The district court also held Liu and Wang each responsible for the entire disgorgement amount under joint-and-several liability. The Ninth Circuit affirmed and the U.S. Supreme Court granted *certiorari*.

In the Court's ***2017 decision*** in *Kokesh v. SEC*, the Court opened the door in a footnote on whether the SEC had the ability to obtain disgorgement at all. In *Kokesh*, the Court held that disgorgement by the SEC constituted a "penalty," and therefore was subject to the general five-year statute of limitations. The *Kokesh* decision has significantly impacted the SEC's enforcement program, ***reportedly*** costing the agency $1.1 billion in recoveries as of 2019. Liu and Wang tried to use *Kokesh* to argue that since disgorgement is a penalty for purposes of the statute of limitations, it is not available as an equitable remedy. They further reasoned that disgorgement is punitive in nature since disgorgement proceeds are often paid to the U.S. Treasury instead of the victims. As was widely expected, the Court rejected these arguments and held that disgorgement is a form of equitable relief available to the SEC.

But, the Court placed important limits on the SEC's ability to obtain disgorgement, an area that historically had few accepted parameters. The Court found that disgorgement is limited to "net profits," which allows defendants to deduct legitimate expenses. The Court also held that disgorgement must be for the benefit of victims instead of going to the SEC. And, the Court indicated that defendants should not be collectively responsible for disgorgement absent special circumstances, like a partnership. Each of these limitations will significantly affect the SEC's ability to obtain disgorgement awards, which overwhelmingly is the most significant monetary remedy available to the agency.

Historically, there has been little guidance by which the SEC was bound in seeking disgorgement awards. Therefore, the SEC has been able to obtain disgorgement awards representing the gross profits obtained from wrongdoers, which often did not go to any investors or other victims. For instance, in a 2019 Foreign Corrupt Practices Act (FCPA) settlement, Microsoft ***agreed*** to disgorge $13.78 million, representing its gross revenue from the alleged improperly obtained business. Consistent with the government's historical approach in FCPA cases, there appears to have been no credit given for Microsoft's legitimate business expenses.

Moreover, the *Liu* decision will help bolster individual defendants' arguments that they should not be responsible for the gains of other defendants, especially non-controlled entities, through the commonly-used theory known as joint-and-several liability. The SEC often seeks to hold all defendants responsible for the collective sum of the ill-gotten gains, regardless of what the particular defendant actually obtained. For example, in May 2020, the SEC ***obtained judgments*** against three individuals in *SEC v. Bershan, et al.*, holding each jointly responsible for disgorgement of all proceeds obtained through a fraudulent securities investment scam. While the Court did not provide bright-line rules in *Liu*, it indicated that holding defendants collectively liable will often result in an impermissible penalty. The Court indicated, for instance, that it may be inappropriate to hold a "tipper" of non-public information liable for the gains of the person who trades on inside information. This would be a significant change in how the SEC has typically handled insider trading cases.

Unfortunately, the Court left a number of important issues for the lower courts to iron out, including guidance on the types of legitimate expenses that may be deducted from ill-gotten gains, under what circumstances a defendant may be responsible for the ill-gotten gains of another wrongdoer, and whether disgorgement is available when the victims of the wrongdoing are not readily identifiable, such as in FCPA cases. While the SEC does have the ability to pay out awards to victims through its Fair Funds program, it does not always do so, which results in the federal government retaining significant disgorgement amounts. Until these issues are sorted out by lower courts or Congress amends the SEC's remedial powers, look for the SEC to try to offset more limited disgorgement through increased civil penalties and to increasingly defer to criminal authorities to seek return of ill-gotten gains through restitution agreements and orders.