# Supreme Court Preserves SEC's Disgorgement Authority, But with Limits

June 23, 2020

**On Monday, June 22, 2020, the Supreme Court decided *Liu v. Securities and Exchange Commission*, the latest decision in a long-running challenge to the SEC's authority to obtain disgorgement in federal court actions. In an 8-1 opinion, the Supreme Court upheld the SEC's authority, but with limitations that raise questions for future litigation.**

## *Background*

As we discussed in an earlier **client memorandum**, the SEC sued Charles Liu and Xin Wang, alleging that they fraudulently led investors to believe that they were funding an enterprise that met the EB-5 immigrant investor program requirements. The district court granted summary judgment to the SEC, issued an injunction, imposed civil monetary penalties, and ordered disgorgement of "all funds received from [the] illegal conduct, together with prejudgment interest thereon," which amounted to $26.4 million.

Shortly thereafter, the Supreme Court decided in ***Kokesh v. Securities and Exchange Commission*** that disgorgement is subject to the five year statute of limitations in 28 U.S.C. §2462 because it constitutes a "penalty." The Court said in a footnote that it was not expressing any opinion about courts' authority to order disgorgement in SEC enforcement proceedings brought in federal, as opposed to administrative, courts. In administrative proceedings, the SEC can seek civil penalties and "disgorgement." In federal court, however, the relevant statute, 15 U.S.C. §78u(d)(5), states that the SEC is authorized to seek "any equitable relief that may be appropriate or necessary for the benefit of investors." The statute does not define "equitable relief" and is silent as to disgorgement.

Liu and Wang relied on *Kokesh* in their appeal to the Ninth Circuit, arguing that the district court lacked authority to award disgorgement under the principles of *Kokesh*. The Ninth Circuit disagreed, holding that the Supreme Court had not reached the issue in *Kokesh* and declined overturning the district court's order. The Supreme Court granted certiorari and has now rendered a decision, affirming the SEC's authority to seek disgorgement but with limitations.

## *Supreme Court Opinion in Liu v. SEC and Three Equitable Principles*

In *Liu*, the Court upheld the SEC's authority to seek disgorgement in district court actions as a form of equitable relief, despite its prior holding in *Kokesh*. The Court noted that "a remedy tethered to a wrongdoer's net unlawful profits, whatever the name, has been a mainstay of equity courts." The Court reconciled this result with its decision in *Kokesh* by explaining that *some* disgorgement awards in SEC cases "exceed the bounds of traditional equitable principles." The Court then discussed three equitable principles that will serve as rough limitations on the SEC's disgorgement authority in future cases.

- First, the Court held that a statutory requirement that equitable relief must be "for the benefit of investors" usually means that funds be returned to the victims. The Court said it "need not address" whether disgorgement might be permissible when it is impractical to distribute funds.

 

- Second, the Court expressed doubt as to whether disgorgement may be sought against multiple individuals via a joint and several liability theory. The Court observed that there might be exceptions, noting that the present case involved spouses who might have acted as "partners in wrongdoing." The Court left this question for the Ninth Circuit to resolve on remand.
- Third, the Court held that the remedy was limited to the "net" profits and that legitimate business expenses generally must be deducted from a disgorgement award, while allowing that expenses need not be deducted in cases in which they are "merely wrongful gains 'under another name.'"

Justice Thomas dissented and would have held that disgorgement is not available under 15 U.S.C. §78u(d)(5) on the basis that disgorgement is a not a traditional equitable remedy.

### *Potential Impact on SEC Enforcement and Future Litigation*

The Court's decision leaves open several issues for future litigation. Of note, the Court's emphasis on returning funds to victims without deciding whether the SEC may obtain disgorgement if a distribution is impractical seems likely to be the subject of further judicial review.

As we **noted** previously, the SEC often does not attempt to return proceeds to investors because of the costs associated with the notification process, claims evaluation, distribution methodology, and the issuance and tracking of hundreds or thousands of payments. This is an issue in many SEC cases in which the expense of a claims process is expected to be quite significant compared to the amount of money available for distribution. As the Enforcement Division noted in its **annual report,** the top 5% of its cases yielded 70% of the total amount of monetary awards for the year, while the remaining 95% resulted in only 30% of the yearly total.

The Court's decision appears to pose the SEC a strategic choice. In cases that previously would not have involved a distribution, the SEC now might attempt a distribution to justify a disgorgement award. Or, the SEC might argue that excessive cost is equivalent to impracticality, and that disgorgement in these cases is consistent with the Court's decision even without returning funds to investors. This may open a new front for litigation over questions of impracticality and cost-benefit analysis. The issue may impact insider trading cases in particular. The SEC usually does not seek to return funds to investors in insider trading cases, where the concept of a "victim" is different than in traditional fraud cases.

The two other equitable principles the Court discussed also will likely have an impact on the SEC, which has long relied on caselaw holding that disgorgement need only be a reasonable approximation of the wrongful gains. *See, e.g., SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989). Following the Court's decision in *Liu*, the SEC will need to deduct legitimate business expenses and delineate the precise amounts received by each defendant. These factors are likely to complicate the SEC's disgorgement calculations and may be subject to further litigation.

In sum, while the *Liu* decision affirms the SEC's disgorgement authority, it leaves unanswered several important questions that are likely to be the subject of litigation. The added evidentiary burden, combined with new litigation risk, may increase the leverage for companies and individuals that are negotiating settlements with SEC staff.

The Supreme Court's opinion is available **here**.

Prior Davis Polk client memoranda discussing the *Liu* case can be found **here** and **here**, and a memorandum discussing *Kokesh* is available **here**.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.


*New York*

| | | |
|---|---|---|
| **Greg D. Andres** | +1 212 450 4724 | greg.andres@davispolk.com |
| **Martine M. Beamon** | +1 212 450 4262 | martine.beamon@davispolk.com |
| **Angela T. Burgess** | +1 212 450 4885 | angela.burgess@davispolk.com |
| **Tatiana R. Martins** | +1 212 450 4085 | tatiana.martins@davispolk.com |

*Washington, DC*

| | | |
|---|---|---|
| **Robert A. Cohen*** | +1 202 962 7047 | robert.cohen@davispolk.com |
| **Neil H. MacBride** | +1 202 962 7030 | neil.macbride@davispolk.com |
| **Fiona R. Moran** | +1 202 962 7137 | fiona.moran@davispolk.com |
| **Annette L. Nazareth** | +1 202 962 7075 | Annette.nazareth@davispolk.com |
| **Paul J. Nathanson** | +1 202 962 7055 | paul.nathanson@davispolk.com |
| **Linda Chatman Thomsen** | +1 202 962 7125 | linda.thomsen@davispolk.com |


*Mr. Cohen is admitted to practice in New York and Maryland, and is practicing in DC under the supervision of partners of the firm.