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.

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- 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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DOJ and SEC Publish Updated FCPA Resource Guide

July 9, 2020

On Friday, July 3, 2020, the Department of Justice's Criminal Division and the Securities and Exchange Commission's Enforcement Division published the *Second Edition* of its *Resource Guide to the U.S. Foreign Corrupt Practices Act*. This is the first update since 2015, and it is comprehensive. The *Second Edition* of the Guide includes, for the first time, the DOJ's FCPA Corporate Enforcement Policy, and contains other helpful updates, including case law developments and other clarifications of the law. The Guide remains an important resource for FCPA practitioners and their clients.

Background

The DOJ Criminal Division and the SEC Enforcement Division published the original Guide in November 2012 to provide guidance on the requirements of the FCPA and insight into DOJ and SEC enforcement practices, including discussions of hypotheticals, precedent, and declinations. Prior to last week's publication of the *Second Edition*, the DOJ and SEC had only updated the Guide once since its original release, with an unannounced and relatively non-substantive revision in 2015.

The *Second Edition* truly is an update to, rather than a departure from, the prior version of the Guide. For example, the *Second Edition* retains the Guide's original structure by updating eight substantive chapters addressing: the FCPA's substantive provisions (chapters 2 and 3); related laws (chapter 4); the guiding principles of enforcement by the DOJ and SEC (chapter 5); penalties, sanctions, and remedies (chapter 6); resolutions (chapter 7); whistleblowers (chapter 8); and the DOJ Opinion Procedure (chapter 9). And, while the Guide provides detailed information, it continues to caution readers that it is "non-binding, informal, and summary in nature, and the information contained [t]herein does not constitute rules or regulations."

That said, the *Second Edition* does reflect important developments in the case law and guidance across a variety of topics. Below is a summary of the *Second Edition's* most notable updates.

DOJ and SEC Policies Applicable to the FCPA

The *Second Edition* incorporates DOJ's FCPA Corporate Enforcement Policy ("CEP"), now located in the "Guiding Principles of Enforcement" section of the Guide. Helpfully, the *Second Edition* adds examples of DOJ declinations under the CEP, including in situations where companies voluntarily self-disclosed conduct. It also includes highlights from the following policies: Selection of Monitors in Criminal Division Matters; Coordination of Corporate Resolution Penalties (also known as the Anti-Piling-On Policy); and the DOJ's Evaluation of Corporate Compliance Programs. And while the Guide is focused on FCPA enforcement, it serves in many ways as a helpful repository of policies relevant to all corporate enforcement matters.

The DOJ's policy on Evaluation of Corporate Compliance Programs was itself recently updated on June 1, 2020. Although the *Second Edition* does not frequently cite to DOJ's policy, the *Second Edition* sounds many of the same notes: the necessity of a "well-functioning and appropriately funded mechanism for the timely and thorough investigations of any allegations"; the value of an investigations structure with "an established means of documenting the company's response, including any disciplinary or remediation measures taken"; and the importance of integrating "lessons learned from any misconduct into the company's policies, training, and controls."

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Design of a Company's Internal Accounting Controls

The *Second Edition* explains that "although a company's internal accounting controls are not synonymous with a company's compliance program, an effective compliance program contains a number of components that may overlap with a critical component of an issuer's internal accounting controls." This is a helpful reminder that while these two regimes may overlap, they should not be coterminous; after all, irrespective of corruption risks, a "financial services company would be expected to devise and employ different internal accounting controls than a manufacturer."

Impact of Recent Case Law

The *Second Edition* acknowledges the limitations the Second Circuit's ruling in *United States v. Hoskins* placed on "agent" liability under the FCPA, but makes clear that *Hoskins* does not apply to the FCPA accounting provisions. The *Second Edition* states that "[u]nlike the FCPA anti-bribery provisions, the accounting provisions apply to 'any person,' and thus are not subject to the reasoning in the Second Circuit's decision in *Hoskins* limiting conspiracy and aiding and abetting liability under the FCPA anti-bribery provisions." See our related client memoranda that can be found **here** and **here**.

The *Second Edition* discusses the definition of "instrumentality" in light of the Eleventh Circuit's decision in *United States v. Esquenazi*. There, the Eleventh Circuit concluded that an "instrumentality" is "an entity controlled by the government of a foreign country that performs a function the controlling government treats as its own," and added that this involves a fact-bound inquiry. The *Second Edition* endorses the Eleventh Circuit's list of factors for conducting such a fact-based inquiry and advises that "[c]ompanies should consider these factors when evaluating the risk of FCPA violations and designing compliance programs."

The *Second Edition* also incorporates recent disgorgement case law following the Supreme Court's decisions in *Kokesh v. Securities and Exchange Commission* and *Liu v. Securities and Exchange Commission*. In *Kokesh*, the Court held that SEC disgorgement claims in federal court actions are subject to a five-year statute of limitations, and in *Liu*, the Court upheld the SEC's authority to obtain disgorgement as an equitable remedy in federal court.

The *Second Edition* does not address the limitations the Court imposed in *Liu*, including that disgorgement generally should be returned to investors. The SEC usually does not return funds to investors in FCPA cases, and the Court did not address whether disgorgement is appropriate if such a distribution is impractical. We note that the SEC's disgorgement authority in administrative proceedings (as opposed to federal court) has not been challenged, and we expect the SEC to continue to file settled FCPA cases in administrative proceedings without distributing disgorged funds to investors. The issue may be the subject of litigation in future SEC FCPA actions that are contested in federal court. See our related client memoranda on ***Kokesh*** and ***Liu***.

Statute of Limitations for FCPA Violations

The *Second Edition* clarifies that "[f]or substantive violations of the FCPA anti-bribery provisions, the five-year limitations period set forth in 18 U.S.C. § 3282 applies. For violations of the FCPA accounting provisions, . . . under 18 U.S.C. § 3301, there is a limitations period of six years." The *Second Edition* also touches on related topics, including situations in which the applicable limitations period is extended.

FCPA Mental State Requirement

The *Second Edition* now reflects that the mens rea requirement is *knowing and willful* for companies and individuals to face criminal liability for failure to comply with the FCPA's books and records or internal controls provisions.

Successor Liability in the M&A Context

The *Second Edition* discusses recent enforcement actions connected to mergers and acquisitions and adds context on the principles of successor liability. In particular, consistent with the DOJ's policy on the Evaluation of Corporate Compliance Programs, the Guide explains that the government recognizes that

pre-acquisition due diligence sometimes is not possible, and that the agencies will look at the timeliness and thoroughness of post-acquisition due diligence and compliance integration.

Examples Addressing Recurring FCPA Issues

The *Second Edition* adds examples that span a range of fact patterns, from travel and entertainment payments to charitable donations to hiring foreign officials' relatives. It includes new examples of FCPA enforcement actions involving third parties, including where third-party sales agents used commission payments to pay bribes.

The *Second Edition* of the Guide is available **here**.

A comparison of the *Second Edition* to the prior edition is available **here**.

Prior Davis Polk client memoranda discussing the Guide can be found **here**.

Other materials of interest include the DOJ **press release** relating to the Guide.

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Davis Polk CLIENT MEMORANDUM

SEC Disgorgement Authority Would Expand in National Defense Authorization Act

December 22, 2020

The National Defense Authorization Act approved by Congress last week would extend to 10 years the time for the SEC to file disgorgement claims for scienter-based violations. It also would toll the limitations period while a party is outside of the United States. As of this writing, the bill awaits the President's signature.

The Backdrop of Liu and Kokesh

As we discussed in a previous **client memorandum**, the Supreme Court in ***Kokesh v. Securities and Exchange Commission*** held that SEC disgorgement claims are subject to the five-year statute of limitations in 28 U.S.C. §2462 because they constitute a "penalty." An open question following *Kokesh* was whether the SEC had authority at all to pursue disgorgement in federal court. As we explained in a **client memorandum**, the Court answered that question earlier this year in ***Liu v. Securities and Exchange Commission*** by upholding the SEC's authority subject to three limiting principles:

- Disgorged funds usually must be returned to the victims. The Court said it need not address whether disgorgement might be permissible when it is impractical to distribute funds;
- The Court expressed doubt as to whether disgorgement may be sought against multiple individuals via a joint and several liability theory;
- The Court held that because the remedy is limited to "net" profits, legitimate business expenses generally must be deducted from a disgorgement award.

National Defense Authorization Act - H.R. 6395

After H.R. 6395 passed the House and Senate and was in Conference Committee earlier this month, portions of Sen. Mark Warner's (D-VA) Illicit Cash Act (S. 2563)[1] were added to the bill. The bill emerged from Committee with newly added Section 6501, intended to address certain aspects of the Supreme Court's rulings in *Kokesh* and *Liu*.[2] On December 11, 2020, after passing the Senate by a vote of 84-13, H.R. 6395 was presented to the President. The President has threatened to veto the bill for unrelated reasons, although the bill passed both the House and Senate with sufficient votes to override a veto.

If H.R. 6395 becomes law, the bill will amend the SEC's disgorgement authority in two significant ways.

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[1] Introduced and referred to Senate Committee on Banking, Housing, and Urban Affairs September 26, 2019.

[2] *Kokesh* and *Liu* have previously drawn congressional attention. *See* Investor Protection and Capital Markets Fairness Act, H.R. 4344, 116th Cong. (2019) (providing that "any Federal court may grant . . . disgorgement in the amount of unjust enrichment.") (passed House Nov. 18, 2019); 165 Cong. Rec. 8929 (daily ed. Nov. 18, 2019) ("[*Kokesh*] was a boon to white collar criminals . . . [e]ven worse, the SEC is currently in litigation before the Supreme Court over whether it even has the authority to obtain disgorgement for investors.").

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First, it will extend the statute of limitations for SEC disgorgement claims to 10 years, but only for scienter-based claims.[3] For all other claims, the statute of limitations would remain at five years consistent with the holding in *Kokesh*.

Second, it will toll the statute of limitations for any disgorgement claim while "the person against which the action or claim" is brought is outside of the United States.

In addition to these changes, the bill also codifies the Supreme Court's holding in *Liu* that the SEC has authority to seek disgorgement in federal district court actions. The bill does not, however, directly address the limiting principles that the Court outlined in *Liu*. Because the bill does not expressly overrule these principles, which the Court said are inherent in the concept of disgorgement, we expect that courts will continue to apply them under the general "prior-construction principle": "Congress should be presumed to have been aware of the scope of 'disgorgement' as interpreted by [] courts and as having incorporated the . . . prevailing meaning of the term into its subsequent enactments."[4]

Practical Implications

The most significant implication of the bill is that it doubles the statute of limitations for disgorgement in the most serious cases—those alleging intentional fraud. Because the extension applies only to disgorgement, not penalties, the impact will be focused on cases involving long-term conduct that potentially could result in sizeable disgorgement claims.

The other change impacts a modest group of cases—those involving a person that is out of the country. The provision would be helpful to the SEC in these matters because the SEC previously has been unsuccessful in arguing for tolling of the statute of limitations. For example, the Supreme Court has held that the statute of limitations should not be tolled during the time when the SEC could not have reasonably discovered a fraud. *See* ***Gabelli v. Securities and Exchange Commission*, 568 U.S. 442 (2013)**. The Supreme Court held instead that the standard rule applied as to government authorities, meaning that the statute of limitations period begins when the alleged violation occurs, not when the SEC discovered it or reasonably could have. *See id.*

The full text of the bill, H.R. 6395, is available **here**.

Prior Davis Polk client memoranda discussing the *Liu* case can be found **here** and **here**.

[3] As recited in the bill, this includes "(I) section 10(b); (II) section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)); (III) section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–6(1)); or (IV) any other provision of the securities laws for which scienter must be established."

[4] *Liu v. SEC*, 140 S.Ct. 1936, 1947 (2020).

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