

SEC Disgorgement Curtailed By Supreme Court

The ruling: The Supreme Court significantly limited the SEC's ability to seek disgorgement. Specifically, the Court held that any award must be limited to the wrongdoer's "net profits" and be awarded "for victims." The Court rejected the expansive concepts used by the agency for years and its repeated practice of paying the sums awarded to the Treasury. Essentially, the remedy has been returned to its historic roots, according to the opinion written by Justice Sotomayor for the Court. *Liu v. Securities and Exchange Commission*, No. 18-1501 (June 22, 2020).

The opinion: There is no doubt that Congress authorized the SEC to seek disgorgement as a remedy, Justice Sotomayor began for the Court. In administrative proceedings Congress specifically added the remedy in the Dodd-Frank Act in 2010. From the beginning Congress authorized the agency to seek "equitable relief" that may be appropriate "for the benefit of investors," according to the Exchange Act. From the beginning the courts have recognized this fact, authorizing the remedy to secure the "profits" a defendant gained from "wrongful" conduct the Court's opinion for eight Justices states, citing *SEC v. Texas Gulf Sulphur Co.*, 446 F. 2nd 1301 (CA2 1971).

Disgorgement is a limited concept, however. It is not and should not be a penalty. In *Kokesh v. SEC*, 581 U.S. ___ (2017) the Court held that an award of what the SEC claimed in that case was disgorgement, in fact constituted a penalty. In *Kokesh* the Court reserved the question of whether the SEC can in fact seek disgorgement. The question is now resolved.

Liu arose from securities sold in connection with an EB-5 immigration project. There investors were solicited to finance a construction project on the promise that when completed each would be on a path to citizenship. When the construction failed to be completed the SEC brought suit claiming fraud. The agency sought remedies that included a return of all investor funds as disgorgement. Defendants – Petitioners before the Court – argued to limit the award of disgorgement. The district and circuit courts

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adopted the SEC's position.

In reaching its conclusion, the Court began with the statutory language cited above. Under the securities laws there is no doubt that the SEC can seek disgorgement as a remedy. Two principles are key here. First, "equity practice long authorized courts to strip wrong doers of their ill-gotten gains . . ." although various labels may have been used for the award. Second, "to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims." Thus, while the courts have not restricted the award to any particular type of case, it is clear that only the net profits are available after "deducting legitimate expenses." The award is available against "culpable actors and for victims . . ."

Finally, the Court declined to parse the facts of this case and apply its ruling, noting that the parties had not specifically addressed the question. Three points should guide the lower courts in undertaking this task. First, the equitable relieve must be for the "benefit of investors," quoting the Exchange Act. The SEC's claim that its use of the remedy is based on a "benefit to the public" misses the mark – the award often is paid to the Treasury. While the agency argued that in some situations it may not be feasible to make such an award, the Court declined to address the issue, but suggested disapproval.

Ultimately, the determination of ill-gotten gains is personal, not one that can be imposed through joint-and-several liability on affiliates and others. The common law did, however, permit "liability for partners engaged in concerted wrongdoing." Finally, the courts must deduct "legitimate expenses" before ordering disgorgement.

Discussion: The Court's opinion is a significant set-back for the SEC. For years the Commission has sought and obtained large disgorgement awards based on its expansive claims about the scope of the remedy. No more. The time of refusing to deduct legitimate expenses from any claim for an award is over. Equally clear is the fact that any request for an award must be strictly limited to ill-gotten gains obtained by the particular defendant – it cannot be expanded by using concepts such as joint-and-several liability.

Now awards of disgorgement must be strictly limited to the wrongful acts of a particular defendant and the net ill-gotten gain obtained by that person from that wrongful conduct, although the ruling does allow that a partnership might be liable for an award. While the Court did not define the specific types of expenses which should be deducted, *Liu* makes it clear that the key is the individual wrongful conduct and the individual who wrongfully obtained net profits.

Finally, while the Court declined to preclude giving the award to the U.S. Treasury as the agency has done for years, the opinion's repeated citation to the statutory language about "investors" all but rules out this approach except perhaps in the most extreme circumstances. Indeed, at the core of the Court's decision is an emphasis on individual, personal responsibility for wrongful conduct and the compensation of individual wronged investors. *Liu* is a highly personal message to the SEC about individual responsibility and

accountability.