Supreme Court *Liu* Decision Upholds SEC Disgorgement Power While Suggesting Potential Limits, and May Impact FTC Enforcement

June 23, 2020

In a decision released yesterday, the U.S. Supreme Court found that the U.S. Securities and Exchange Commission ("SEC" or "Commission") could seek disgorgement in certain of its enforcement actions. The Court held that a "disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims" is equitable relief permissible under the statute. *Liu v. SEC*, No. 18-1501, slip op. at 1 (S. Ct. June 22, 2020). Although the holding itself is limited, the Court telegraphed its view that the SEC might exceed its authority to seek disgorgement if the SEC: (1) requires that defendant's gains be deposited with the U.S. Treasury instead of returned to victims; (2) imposes joint-and-several liability; or (3) declines to deduct legitimate business expenses from the award. This combination of requiring both the deduction of legitimate business expenses from the disgorgement amount and that the disgorgement be intended for "victims" of the violation, could have a substantial impact on the SEC's ability to obtain disgorgement in numerous types of cases.

In this Client Update, we explore the ruling's implications for negotiating SEC settlements and the questions left unanswered by the Court. In short, while the Court's decision allows the award of disgorgement under certain circumstances, it could have the practical effect of significantly limiting disgorgement in many types of cases, including FCPA, insider trading, and even enforcement by other administrative agencies such as the FTC.

Background

Three years ago, the Supreme Court significantly curtailed the SEC's ability to seek disgorgement in its enforcement cases when the Court held that disgorgement acts as a penalty and is therefore subject to a five-year statute of limitations. *Kokesh v. SEC*, 137 S.Ct. 1635 (2017). *Liu* presented the Supreme Court with the opportunity to address a

question it expressly reserved in *Kokesh*: whether courts possess the authority to order disgorgement in SEC enforcement proceedings at all. *See Kokesh*, 137 S. Ct. at 1645 n.3.[1]

The underlying facts in *Liu* related to a purported scheme to defraud foreign nationals perpetuated by Petitioners Charles Liu and his wife, Xin (Lisa) Wang. The pair solicited nearly $27 million from foreign investors under various investor programs administered by the U.S. Citizenship and Immigration Services meant to permit "noncitizens to apply for permanent residence in the United States by investing in approved commercial enterprises that are based on 'proposals for promoting economic growth.'" *See Liu*, slip op. at 4. The offering memorandum stated that investor funds would be used to pay for the construction costs of a cancer treatment center with amounts collected from a small administrative fee being used for "'legal, accounting and administration expenses.'" *See id*.

The SEC's investigation concluded, however, that $20 million of investor funds were spent on alleged marketing expenses and salaries in excess of what the offering memorandum disclosed, while only a fraction of the funds were put toward a lease, property improvements, and a proton therapy machine for cancer treatment. *See id*. The SEC sought disgorgement, on a joint and several basis, equal to the full amount Petitioners had raised from investors, less the $234,899 remaining in the corporate accounts. *See id*. at 5.

Supreme Court Decision

The Court limited its holding to the question of whether disgorgement can qualify as "equitable relief" under Section 78u(d)(5), given that equity historically excludes punitive sanctions. In an 8-to-1 decision, the Court held that, as a general rule, disgorgement awards are an appropriate equitable remedy when restricted to awards of net profits from wrongdoing that are awarded to victims. *See id*. at 1. After stating this general principle, the Court then applied that principle to three different aspects of potential disgorgement awards that the Petitioners had raised. Although the Court declined definitively to resolve them, *see id*. at 14, it offered important guidance on each of these three issues.

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[1] See Bruce E. Yannett, Colby A. Smith, Philip Rohlik, Jil Simon, "Taking the Statue of Limitations Seriously: Applying *Kokesh*, District Court Dismisses SEC Claims Seeking "Obey-the-Law" Injunction," FCPA Update, Vol. 9, No. 12 (July 2018), https://www.debevoise.com/insights/publications/2018/07/fcpa-update-july-2018; Mary Jo White, Andrew Ceresney, Kara Brockmeyer, Robert Kaplan, Julie Riewe, and Jonathan Tuttle, *What Kokesh v. SEC Means For Enforcement Actions*, LAW360 (June 8, 2017), https://www.law360.com/articles/932661/what-kokesh-v-sec-means-for-enforcement-actions.

For the Benefit of Investors

First, the Court addressed the question of whether disgorgement may be awarded only if the funds are paid to victims. The Court cited to the language of Section 78u(d)(5), which restricts equitable relief to that which "may be appropriate or necessary for the benefit of investors." *See id*. The SEC argued that the primary function of depriving wrongdoers of profits is to deny them the fruits of their ill-gotten gains, not to return the funds to victims as restitution. *See id.* at 15. The Court rejected that argument, stating that the SEC's equitable, profits-based remedy must do more than benefit the public at large to satisfy the statute's "for the benefit of investors" requirement. *See id*. at 15-16.

The SEC further argued that its practice of depositing disgorgement funds with the Treasury may be justified when it is not feasible to return funds to investors. *See id*. at 16. The Court was unconvinced, stating that it is an "open question" whether, and to what extent, that practice satisfies the SEC's statutory obligation to award relief "for the benefit of investors." *See id*. at 16-17. While the Court noted that it was not ruling out the possibility that a future court could find that the SEC has demonstrated that disgorgement benefits investors if there is evidence demonstrating the infeasibility of returning funds to investors, its decision seems to suggest the Court would not find disgorgement to be an equitable remedy under such a scenario. *See id*.

Given the Court's skepticism that disgorgement can be awarded when the funds are not distributed to investors, the decision may significantly restrict the SEC's ability to collect disgorgement where the funds cannot be distributed to victims, including FCPA and insider trading cases where traditionally, disgorgement funds have not been distributed to "victims." In FCPA cases, the SEC routinely collects very large disgorgement judgments and sends the funds directly to the Treasury. *See, e.g.*, SEC Press Rel. 2019-254 (Ericsson agreed to pay more than $539 million in disgorgement and prejudgment interest); *In the Matter of Walmart Inc.*, Exchange Act Rel. No. 86159 (June 20, 2019) (Walmart agreed to may more than $144 million in disgorgement and prejudgment interest); SEC Press Rel. 2019-48 (Fresenius Medical Care agreed to pay more than $147 million in disgorgement and prejudgment interest). It is unclear to what extent the SEC in FCPA cases could identify a specific injured investor, or even injured party.

Similarly, in insider trading cases, the only arguable "victims" are traders who traded contemporaneously with the insider trading. *See, e.g.*, SEC Press Rel. 2019-257 (Dec. 9, 2019) (Former U.S. Representative Christopher Collins and two others agreed to disgorge avoided losses of $634,299); *In the Matter of Tai-Cheng Yang*, Exchange Act Rel. No. 85525 (April 5, 2019) (Yang agreed to disgorge $27,761.55). Yet the SEC has only rarely distributed such funds given the difficulty of identifying counterparties to the

illegal insider trading and the impracticability of distributing *de minimis* funds to victims, a situation common in cases both large (*e.g.*, corporate malfeasance and disgorgement to shareholders) and small (*e.g.*, when, based on defendant's demonstrated inability to pay, the distribution fund would not support the cost of the distribution). Although it remains to be seen how lower courts and the SEC will interpret the Court's guidance, the decision nevertheless calls longstanding practices into question.

Joint-and-Several Liability

Second, the Court stated that the SEC's practice of imposing joint-and-several disgorgement liability on a wrongdoer's affiliates could transform the remedy into a penalty. *See Liu*, slip op. at 17. Joint-and-several liability runs counter to the common law principle of holding defendants individually liable for wrongful profits by extending liability to the profits that had accrued to another, and in which the defendant had no participation. *See id*. at 17-18. The Court recognized there are situations that permit collective liability for partners in wrongdoing "given the wide spectrum of relationships between participants and beneficiaries of unlawful schemes." *See id*. at 18.

The Court's ruling may restrict the SEC's ability to pursue disgorgement from those who did not directly profit from misconduct and will require the SEC to provide clearer evidence of concerted action when attempting to pursue joint-and-several disgorgement liability. For example, the Court suggested that unrelated tipper-tippee arrangements in an insider trading context fall on the "more remote" end of that spectrum where individual liability may be required. *See id*.

Net Profits

Finally, the Court stated that in seeking disgorgement, the SEC must deduct legitimate expenses from the disgorgement amount, provided the business as a whole is not a sham used in pursuit of the wrongdoing. *See id*. at 18-19. Here, the Court noted that some expenses from Petitioners' scheme, such as lease payments and cancer-treatment equipment, had value independent of furthering the scheme. *See id*. at 19. The Court's ruling may have significant implications in connection with negotiating settlement agreements with the SEC, particularly in insider trading and other types of trading cases, where the SEC typically declines to allow the defendant to deduct commissions or other legitimate expenses, or in FCPA cases, where the decision could be used to justify deduction of overhead expenses. The decision provides ammunition to parties arguing for a broader expansion of what constitutes legitimate, deductible expenses.

Potential Impact on FTC Enforcement

The *Liu* decision may also have a significant impact on Federal Trade Commission ("FTC") enforcement. Although the Federal Trade Commission Act ("FTCA") does not grant the FTC statutory authority to obtain restitution or disgorgement, for many years the FTC has relied upon Section 13(b) of the FTCA (which authorizes injunctive relief) to obtain equitable restitution or disgorgement in Federal court.

The FTC has frequently argued that equitable monetary relief, whether characterized as restitution or disgorgement, can be calculated based upon the revenues received by the alleged wrongdoer (*i.e.* consumer losses) and should not be limited to net profits. The FTC has also held multiple defendants jointly and severally liable for consumer losses. Based upon the *Liu* decision, however, FTC equitable relief may now be limited to net profits, and joint-and-several liability for monetary relief may no longer be available. Accordingly, companies investigated by the FTC may be more reluctant to agree to settlements containing monetary relief (known as "consumer redress"), particularly if the monetary relief is not tethered to net profits.

Last year, the Seventh Circuit, in *FTC v. Credit Bureau Center*, held that the FTC does not have authority to obtain equitable restitution at all under Section 13(b) of the FTCA. *FTC v. Credit Bureau Center*, 937 F.3d 763 (7th Cir. 2019). The FTC filed a petition for writ of certiorari asking the Supreme Court to review the Seventh Circuit's decision. The Supreme Court has not yet ruled on the pending petition and it is unclear if the *Liu* decision will impact the ruling.

The FTC is presumably relieved that the *Liu* decision upheld the issuance of equitable monetary relief, but may argue that the restrictions enunciated by the Supreme Court in the *Liu* decision are inapplicable to the FTC (and limited to the SEC) based upon different statutory language (authorizing injunctions rather than "equitable relief"), different statutes, and the fact that FTC monetary relief in the first instance is provided to consumers to compensate for losses, rather than the U.S. Treasury. Regardless, at least for now the *Liu* decision may impact the FTC's enforcement powers outside the Seventh Circuit as described above.

Key Takeaways

The *Liu* decision raises important questions about the limitations of the SEC's ability to pursue disgorgement in all circumstances. The Court has approved disgorgement when the disgorgement award constitutes net profits and the award is distributed to victims, but *Liu* leaves open the question of whether the SEC can continue to pursue a

disgorgement remedy when funds cannot be distributed to investors, thereby casting a significant shadow over one of the SEC's most powerful enforcement tools. It will be up to lower courts to interpret the Court's guidance on "those categories of relief that were *typically* available in equity" to determine the contours and limits of SEC disgorgement powers. The longer term implications of the decision remain to be seen; the most likely impact in the short term is on the leverage that parties have in negotiating SEC settlements. Finally, as noted above, the decision may also impact FTC enforcement and negotiated settlements.

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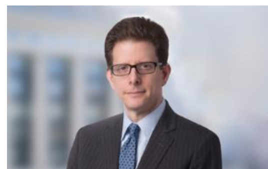

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