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Insights

SUPREME COURT AFFIRMS SEC DISGORGEMENT POWERS, BUT WITH LIMITS

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Liu v. Securities and Exchange Commission, the U.S. Supreme Court decision this week affirming the SEC's right to seek disgorgement, displayed a striking consensus on the securities regulatory agency's ability to seek return to investors of wrongdoers' ill-gotten gains. The decision was not a complete victory for the SEC, however, since the Court also emphasized limitations on disgorgement that it suggested the SEC had exceeded with its past practices.

At issue was a remedy the SEC has long claimed the right to seek in civil enforcement actions: disgorgement of the defendant's gains for return to injured investors. The SEC in many fraud cases seeks both civil penalties, as authorized by statute, as well as disgorgement as an equitable remedy. And courts generally permit that practice.

In light of certain recent Court rulings against the SEC on various issues and the Roberts court majority's attitude toward administrative agencies generally, some securities practitioners anticipated a ruling in **Liu** that courts lacked the power to order disgorgement as a remedy in securities enforcement civil actions, upsetting years of prior judicial practice. However, the Court's June 22 decision in **Liu** affirmed the SEC's right to seek disgorgement by an 8-1 vote, with only Justice Clarence Thomas dissenting.

The majority opinion by Justice Sonia Sotomayor did identify certain limits on disgorgement, which may constrain the SEC from seeking disgorgement as freely as it has in the past. The opinion also articulated those limits in a manner that leaves substantial room for argument over how they will be interpreted and applied in future cases.

Liu began as an SEC action in U.S. District Court. In SEC actions pursued in administrative proceedings, a statute expressly authorizes the agency to seek both civil penalties and disgorgement. In SEC actions pursued in District Courts, however, the relevant statute does not use the word disgorgement, but authorizes courts to award civil penalties and "equitable relief." The scope of that relief is not further defined, but the SEC and courts have treated SEC requests for disgorgement as within the meaning of equitable relief.

Unlike other equitable remedies such as injunctive and declaratory relief, disgorgement means the defendant pays money. Three years ago, in *Kokesh v. SEC*, the Supreme Court ruled that for statute-of- limitations purposes, disgorgement was a "penalty" subject to the 5-year limitations period for actions to enforce a "civil fine, penalty or forfeiture." In a footnote, the Court also noted that it expressed no opinion on "whether courts possess authority to order disgorgement in SEC enforcement proceedings."

Kokesh led some securities and appellate lawyers to conclude that the Court would be receptive to a challenge to the SEC's right to seek disgorgement. Under traditional legal principles, an equitable remedy may not be punitive. So if disgorgement was really a penalty, as **Kokesh** stated, then it was not an equitable remedy and could not be justified as coming within the government's historical power to seek "equitable relief" in civil actions. The result would have been dramatic.

The **Liu** oral argument in March, however, left the impression that the majority of the Court was not willing to go that far. That impression was correct: as it turned out, only Justice Thomas believed disgorgement was not permitted as equitable relief.

Although it did not say so directly, under the majority's approach, the fact that disgorgement is a penalty for statute-of-limitations purposes does not make disgorgement a penalty for all purposes. Instead, in interpreting the meaning of "equitable relief," the Court looked to whether disgorgement falls into the "categories of relief" historically available in equity.

The opinion surveyed the history of equity jurisprudence, and concluded that disgorgement was a form of relief historically available in equity, and therefore that the securities laws' authorization of equitable relief did include disgorgement.

But the Court went on to identify key principles limiting the use of disgorgement as an equitable remedy, and pointed out ways in which the SEC's uses of the remedy, as approved by some courts, "test the bounds of equity practice":

(i) depositing disgorgement awards in the U.S. Treasury rather than returning the funds to injured investors;

(ii) failing to deduct wrongdoers' expenses from the amount of an award, since an equitable, and non-punitive, remedy should only recover net profits; and

(iii) imposing joint and several liability for disgorgement awards on co-defendants, which could result in defendants disgorging more than their own net profits.

Because the parties in **Liu** had focused on the broader question of whether disgorgement was available at all as an equitable remedy, the Court did not decide how those limiting principles applied to the case itself, but rather sent the matter back for the lower court to address in light of the Supreme Court's opinion.

The Court’s discussion of these restraining principles left ample room for debate. For example, is payment of an award to the Treasury permitted if the SEC can show it is not feasible to return money directly to injured investors? While a joint-and-several liability award appears inconsistent with the decision, the opinion indicated there may be tolerance for “collective liability” if the SEC shows that the defendants were partners “engaged in concerted wrongdoing.” What does that mean?

Even the net profits principle will likely give rise to disputes. Under **Liu**, where a defendant raises a large sum from investors by means of fraud, and spends some of that money on actual expenses, it seems that the **Liu** principles limit the disgorgement amount to the net profit, not the total sum raised from investors. But the SEC will be free to argue in a particular case that purported expenses are a disguised form of gain rather than legitimate expenses –for example, if the expenses are payments that benefit the defendants themselves.

Other questions raised by the decision include how disgorgement will be awarded to injured investors in insider trading cases, where the injured party is difficult to identify, as distinct from a Ponzi scheme where funds are fraudulently obtained from identifiable investors.

Thus, the Supreme Court in *Liu* resolved a major issue, the SEC’s power to seek disgorgement in federal court enforcement actions. However, as is often the case, the decision left unresolved a number of subsidiary questions ripe for litigation in future actions.

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