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Disgorgement Under Fire

By *Teresa Goody Guillén, Jeffrey D. Martino and Michelle N. Tanney**, BakerHostetler

On March 3, the U.S. Supreme Court will weigh whether the U.S. Securities and Exchange Commission (SEC or Commission) has the authority to obtain, in federal court, disgorgement of ill-gotten gains from defendants who violated federal securities laws. For decades, disgorgement has been one of the most effective enforcement powers of the SEC and broadly accepted as a form of equitable relief. *Liu v. SEC* seeks to upend this practice by stripping the SEC of its disgorgement power outside the context of an administrative proceeding, wreaking certain havoc in its wake by forcing other federal agencies, such as the Federal Trade Commission (FTC), to stand in defense of their own statutory powers.

Background

Disgorgement is a remedy that the SEC uses to recover wrongdoers' ill-gotten gains and, in many cases, to return these gains to victims.¹ Federal securities laws authorize the SEC to seek injunctive relief in federal district courts, which in turn have equitable powers to order appropriate remedies for wrongdoing. The Securities Exchange Act of 1934 (the Exchange Act) specifically authorizes the SEC to obtain disgorgement as a civil remedy in administrative proceedings,² but the Commission has successfully obtained disgorgement in other forums and in a wide variety of matters, including offering frauds, Foreign Corrupt Practices Act (FCPA) resolutions and settlements with regulated entities.³ For decades, the SEC has obtained disgorgement in enforcement proceedings brought in federal court even though no statute expressly authorizes it to seek and obtain disgorgement in an enforcement action.⁴

Congress first enabled the SEC to seek monetary penalties against public companies in the 1990s.⁵ At that time, Congress anticipated that the Commission would seek disgorgement only when a securities law violation improperly benefited shareholders rather than circumstances in which

* **Teresa Goody Guillén** is a partner in the Washington, D.C. office of BakerHostetler. She has a broad-based securities and corporate practice that includes SEC investigations, securities litigation, assistance interacting with regulators and the government, and general securities and corporate advice. **Jeffrey Martino** is a partner at BakerHostetler and former chief of the U.S. Department of Justice's Antitrust Division in New York. **Michelle N. Tanney** is an associate in the firm's New York office.

1 Fair Funds were created by the Sarbanes-Oxley Act of 2002 and hold money recovered from an SEC case, which is distributed to injured investors. See 15 U.S. Code § 7246.

2 The Exchange Act, 15 U.S.C. § 78u-2(e)

3 Steven Peikin, U.S. Sec. & Exch. Comm'n, speech, "Remedies and Relief in SEC Enforcement Actions" (Oct. 3, 2018), available at <https://www.sec.gov/news/speech/speech-peikin-100318>.

4 See Securities Enforcement Remedies and Penny Stock Reform Act, 101-420 Stat. 931, codified as 15 U.S.C. § 77t(d), which authorized the SEC to seek civil monetary penalties in enforcement cases. Before its enactment, the Commission's authority was generally limited to the ability to seek penalties in district court for insider trading violations.

5 *Id.*

shareholders were themselves the victims. For more than 10 years, the SEC put this into practice, but in 2002, the Commission penalized Xerox Corp. an “unprecedented” \$10 million,⁶ which was three times the size of any previous penalty for similar cases. This expansive view continues to result in significant disgorgement orders against individuals and corporations. In fiscal year 2019 alone, the SEC obtained a total of \$3.248 billion in disgorgement, compared with monetary penalties that totaled \$1.01 billion.⁷

The Impact of *Kokesh*

While disgorgement historically has been viewed as an equitable remedy designed to prevent wrongdoers’ unjust enrichment, a 2017 Supreme Court decision cast doubt on the SEC’s authority to obtain disgorgement generally. In *Kokesh v. SEC*,⁸ the Court held that disgorgement operates as a penalty within the meaning of 28 U.S.C. § 2462 and is therefore subject to a five-year statute of limitations. In making its determination, the Court reasoned that disgorgement addresses a wrong committed against the public through the imposition of punitive measures (e.g., deterrence) rather than equitably compensating victims for their losses.⁹ Notably, however, the Court expressly declined to rule on whether the courts have the authority to award disgorgement in enforcement actions, effectively flagging this as an open question.¹⁰

In the SEC Enforcement Division’s *2019 Annual Report*, the Commission noted that *Kokesh* has adversely impacted its ability to disgorge and return funds to investors.¹¹ The Enforcement Division estimates that the *Kokesh* ruling has caused the Commission to forgo approximately \$1.1 billion in disgorgement in filed cases.¹² Accordingly, the SEC has shifted resources to investigations that are more likely to result in returning funds to investors and has lobbied Congress to assist in efforts to counteract the Court’s ruling.¹³ SEC Chairman Jay Clayton has also expressed certain frustration with the decision, claiming that he is “troubled by the substantial amount of losses” the SEC is now unable to recover for investors.¹⁴ He therefore called on Congress to address *Kokesh* to ensure that investors “can get their investment dollars back.”¹⁵

In November 2019, the House of Representatives passed a bipartisan measure that would address the concerns raised by Clayton. The Investor Protection and Capital Markets Fairness Act (H.R. 4344) would amend the Exchange Act to authorize the SEC to seek and federal courts to order

6 U.S. Sec. & Exch. Comm’n, press release, “Xerox Settles SEC Enforcement Action Charging Company With Fraud” (April 11, 2002), available at <https://www.sec.gov/news/headlines/xeroxsettles.htm>.

7 U.S. Sec. & Exch. Comm’n, Division of Enforcement, *2019 Annual Report* (Annual Report), p. 16, available at <https://www.sec.gov/enforcement-annual-report-2019.pdf>.

8 137 S. Ct. 1635 (2017).

9 *Id.* at 1643-44.

10 *Id.* at 1642 n.3.

11 Annual Report at p. 21.

12 *Id.*

13 *Id.*

14 Jay Clayton, testimony on “Oversight of the U.S. Securities and Exchange Commission” (Dec. 11, 2018), available at <https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission-0>.

15 *Id.*

disgorgement of ill-gotten gains.¹⁶ The bill explicitly instructs that disgorgement “may not be construed to be a civil fine, penalty, or forfeiture” subject to Section 2462 and seeks to give the SEC 14 years to pursue disgorgement in federal court.¹⁷ The legislation is presumed to take into account the time regulators need to investigate the cases that often take longer to identify and resolve, like FCPA and foreign bribery-related matters. The Senate, in parallel, also drafted bipartisan legislation, the Securities Fraud Enforcement and Investor Compensation Act (S. 799), which is sitting in the Committee on Banking, Housing and Urban Affairs and would set a 10-year statute of limitations.¹⁸

The Current Challenge Before the Supreme Court

On Nov. 1, 2019, the Supreme Court granted *certiorari* in *Liu v. SEC* to address the open question from *Kokesh*: whether the SEC has the authority to obtain disgorgement in actions to enforce federal securities laws.

The *Liu* case began in 2016, when the SEC sued Charles Liu and Xin “Lisa” Wang for defrauding investors by misusing funds solicited under the EB-5 program authorized by U.S. Citizenship and Immigration Services for an alleged private placement offering in a cancer treatment center.¹⁹ In 2017, the district court granted relief to the SEC in the form of \$27 million in disgorgement and \$8.2 million in civil monetary penalties, and it enjoined the defendants from soliciting future investments.²⁰ Liu and Wang appealed to the U.S. Court of Appeals for the 9th Circuit, arguing that the district court lacked statutory authority to order disgorgement because, under *Kokesh*, disgorgement is a penalty rather than an equitable remedy. In 2018, the 9th Circuit affirmed the disgorgement award, finding that *Kokesh* was not “clearly irreconcilable” with … longstanding precedent on this subject.”²¹

In the petition filed with the Supreme Court, petitioners Liu and Wang argue that while Congress authorized the SEC to seek enumerated remedies, those remedies do not include disgorgement, which is specifically authorized only in administrative proceedings. According to the petitioners, this deliberate omission demonstrates that Congress did not intend to grant disgorgement authority at all and that the remedies currently available to the SEC leave it “more than amply equipped” to enforce the securities laws without disgorgement powers.²² To support their claim, the petitioners contend that the SEC, as in their case, routinely seeks disgorgement orders that force defendants to pay amounts exceeding their personal gains from unlawful activities.²³ In such cases, therefore,

16 H.R. 4344, the Investor Protection and Capital Markets Fairness Act, congress.gov, available at <https://congress.gov/bill/116th-congress/house-bill/4344/>.

17 *Id.*

18 S. 799, the Securities Fraud Enforcement and Investor Compensation Act, congress.gov, available at <https://www.congress.gov/bill/116th-congress/senate-bill/799>.

19 *SEC v. Liu*, 262 F. Supp. 3d 957, 970-72 (C.D. Cal. 2017).

20 *Id.* at 973-76.

21 *SEC v. Liu*, 754 F. App’x 505, 509 (9th Cir. 2018).

22 *Liu v. SEC*, No. 18-1501 (S. Ct. filed Dec. 16, 2019), Br. for Pet’rs at 17-20, 42.

23 *Id.* at p. 24 (see also *Kokesh*, 137 S. Ct. at 1644-45). The amount the petitioners “personally” gained from their alleged scheme was purportedly \$8 million total, but the disgorgement order required them to pay nearly \$27 million. The disgorgement order was calculated based on the amount raised by the petitioners less the money paid back to investors. The petitioners argue, however, that neither the district court nor the Court of Appeals allowed a reduction of their expenses that reduced the amount of their actual illegal profit, rendering the disgorgement order a penalty that left the petitioners worse off.

disgorgement is not used to restore the status quo but rather “leaves the defendant worse off.”²⁴ This, according to the petitioners, is inconsistent with the spirit of equity – an “instrument for nice adjustment and reconciliation” – and instead leaves disgorgement to act as a punishment.²⁵

In opposition, the SEC first argues that the Securities Act of 1933 and the Exchange Act both authorize a federal court to “enjoin” violations,²⁶ which “encompasses the power to order a violator ‘to disgorge profits … acquired in violation’ of the relevant statutory provisions.”²⁷ The SEC further argues that Congress has authorized the courts to order “any equitable relief that may be appropriate or necessary for the benefit of investors”²⁸ and that the Court has “repeatedly characterized disgorgement as an equitable remedy.”²⁹ The SEC claims that the petitioners’ reliance on *Kokesh* is misplaced, insisting that the Supreme Court determined disgorgement was a penalty within the meaning of the statute of limitations, which can be squared with other precedent describing disgorgement as equitable relief for other purposes. The SEC also attacks the petitioners’ practical arguments, contending that eliminating court-ordered disgorgement would enable wrongdoers to keep their ill-gotten gains and reduce the deterrent effect of the current remedial scheme.³⁰ Moreover, the Commission argues that victims left without recourse to the disgorgement funds would be forced to bring their own private actions, which are “narrow” in scope under the Supreme Court’s jurisprudence.³¹

The FTC’s Enforcement Authority Hangs in the Balance

The outcome in *Liu* may be far reaching and could extend beyond the SEC to other federal agencies, such as the FTC. Like the SEC, the FTC relies on disgorgement of ill-gotten gains as a remedial tool; accordingly, a Supreme Court ruling that disgorgement is not within the SEC’s statutory authority may force the FTC to distinguish restitution to consumers under Section 13(b) of the Federal Trade Commission Act (FTC Act)³² from disgorgement under the securities laws or potentially engage in a complete overhaul of its fraud program.

Section 13(b) authorizes the FTC to “seek preliminary and permanent injunctions to remedy ‘any provision of law enforced by the Federal Trade Commission.’”³³ It has long been a “mainstay” of the FTC’s consumer protection program.³⁴ On the antitrust side, however, the FTC initially brought

24 *Id.*

25 *Id.* (citing *Hecht Co. v. Bowles*, 321 U.S. 321, 329-30 (1944)).

26 *Liu* (S. Ct. filed Jan. 15, 2020), Br. for Resp’t at 5 (citing 15 U.S.C. 77t(b), 78u(d)(1)).

27 *Id.* (citing *Porter v. Warner Holding Co.*, 328 U.S. 395, 398-399 (1946) (“Nothing is more clearly a part of the subject matter of a suit for an injunction than the recovery of that which has been illegally acquired and which has given rise to the necessity for injunctive relief.”)).

28 *Id.* at 5 and 7 (relying on the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745).

29 *Id.* at 5 and 7 (citing cases).

30 *Id.* at 42.

31 *Id.* at 43.

32 Codified as 15 U.S.C. § 53(b).

33 Fed. Trade Comm’n, *A Brief Overview of the Federal Trade Commission’s Investigative, Law Enforcement, and Rulemaking Authority* (October 2019), available at <https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority>.

34 David M. Fitzgerald, *The Genesis of Consumer Protection Remedies Under Section 13(b) of the FTC Act*, available at https://www.ftc.gov/sites/default/files/documents/public_events/FTC%2090th%20Anniversary%20Symposium/fitzgeraldremedies.pdf.

very few antitrust actions under Section 13(b), and it reiterated this approach in its 2003 Policy Statement on Monetary Equitable Remedies in Competition Cases, when it stated that it did “not view monetary disgorgement or restitution as routine remedies for antitrust cases.”³⁵ By 2012, however, the FTC withdrew from this policy, stating that it would instead “rely on existing law.”³⁶ Now the FTC makes considerable use of this provision of the FTC Act in the competition context by not only obtaining preliminary injunctive relief against corporate mergers or acquisitions pending completion of an FTC administrative proceeding, but also, in certain circumstances, by obtaining disgorgement of unjust enrichment.³⁷

The FTC, like the SEC, is facing several challenges to these powers. On Dec. 19, 2019, the FTC – in the absence of the U.S. Solicitor General – filed its own petition for *certiorari*³⁸ following the U.S. Court of Appeals for the 7th Circuit’s decision in *FTC v. Credit Bureau Center LLC*, which found that Section 13(b) authorizes *only* restraining orders and injunctions and not restitutionary relief.³⁹ The 7th Circuit reasoned that while Section 13(b) provides the FTC the authority to issue an injunction, the statute does not authorize restitution because, quite simply, “[r]estitution isn’t an injunction.”⁴⁰ The court also noted the FTC’s position that Section 13(b) implicitly authorizes restitution, but it held that such an implication does not “sit comfortably within the text of 13(b)” because injunctive relief, which the statute speaks to, is a forward-thinking remedy rather than a restorative one.⁴¹

In its petition to the Supreme Court, the FTC opines that for decades, the district courts granted the FTC the authority to obtain permanent injunctions under Section 13(b)⁴² and the authority to require wrongdoers to return money that was illegally obtained.⁴³ The FTC avers that the 7th Circuit disrupted “longstanding precedent” in finding that restitution “isn’t an injunction” because injunctions are forward-facing remedies and restitution is a remedy for past actions.⁴⁴ In support of its position, the FTC states that its position is consistent with legislative intent, using decisions in *Porter v. Warner Holding Co.*⁴⁵ and *Mitchell v. Robert DeMario Jewelry Inc.*,⁴⁶ which purportedly

35 68 Fed. Reg. 149 (Aug. 4, 2003).

36 U.S. Fed. Trade Comm’n, press release, “FTC Withdraws Agency’s Policy Statement on Monetary Remedies in Competition Cases; Will Rely on Existing Law” (July 31, 2012), available at <https://www.ftc.gov/news-events/press-releases/2012/07/ftc-withdraws-agencys-policy-statement-monetary-remedies>.

37 See note 31 *supra* (citing *FTC v. U.S. Oil & Gas Corp.*, 748 F.2d 1431, 1432-35 (11th Cir. 1984)).

38 Fed. Trade Comm’n v. Credit Bureau Ctr., LLC, No. 19-825 (S. Ct. filed Dec. 19, 2019).

39 Fed. Trade Comm’n v. Credit Bureau Ctr., LLC, 937 F.3d 764, 767 (7th Cir. 2019).

40 *Id.* at 771.

41 *Id.* at 772.

42 Notably, in February 2019, the U.S. Court of Appeals for the 3rd Circuit implied that there’s a question whether Section 13(b) authorizes equitable monetary relief. *FTC v. Shire ViroPharma, Inc.*, 917 F.3d 147 (3rd Cir. 2019) (rejecting the FTC’s standalone claim for equitable monetary relief but declining to rule whether that relief would be authorized, stating that “[a]ssuming that such relief is available under Section 13(b)”).

43 *Credit Bureau Ctr.*, No. 19-825 (S. Ct. filed Dec. 19, 2019) at 3.

44 *Id.* at 7.

45 328 U.S. 395 (1946) (finding it “readily apparent” that the district court could enter an injunction that also requires the return of illegally collected rents under the language of a federal rent control statute).

46 361 U.S. 288 (1960) (upheld a monetary judgment entered under the Fair Labor Standards Act that empowered district courts to restrain violations).

underly the notion that a district court exercising authority to enjoin regulatory violations may order disgorgement or restitution⁴⁷ absent a congressional directive to the contrary.⁴⁸ Specifically, the FTC argues that in 1994, Congress reviewed the FTC Act and decided not to alter its permanent injunction clause despite the fact that multiple courts of appeals had by then “recognized that Section 13(b) authorizes order to return ill-gotten gains to consumers.”⁴⁹ This, the FTC argues, is “convincing support for the conclusion that Congress accepted and ratified the unanimous holdings of the Courts of Appeals.”⁵⁰ *Credit Bureau* joins two other petitions for *certiorari* pending before the Supreme Court seeking review of the FTC’s practice under Section 13(b) regarding monetary awards: *Publishers Business Services v. FTC*⁵¹ and *AMG Capital Management v. FTC*.⁵² Unlike in *Credit Bureau*, the U.S. Solicitor General responded on behalf of the FTC in both matters – as is common practice – but argued that the petitions for *certiorari* should be denied or, conversely, held in abeyance pending the Court’s decision in *Liu*. Following this line of thinking, the Solicitor General filed a request for an extension of time to petition for a writ of *certiorari* in *Credit Bureau*, stating,

The additional time sought in this application is needed to complete consultation with interested agencies and components of the government and to assess the legal and practical impact of the court of appeals’ ruling, including the relationship between the question presented here and the question presented in *Liu v. SEC*.⁵³

In addition, numerous former FTC senior officials collectively filed a brief of *amici curiae* in *Liu* to urge the Court “to be cautious not to restrict enforcement cases seeking *compensatory* equitable remedies” despite the 7th Circuit’s holding in *Credit Bureau*.⁵⁴ In their brief, the *amici* argue that (1) actions for compensatory redress have always been equitable in nature and (2) enforcement actions by both the SEC and FTC to prevent unjust enrichment are authorized by statutes empowering injunctive relief *and* by the courts’ equity jurisdiction, regardless of whether provisions of disgorgement orders may constitute a penalty under 28 U.S.C. 2462.⁵⁵

47 The purpose of restitution is to compensate victims for their loss, regardless of the amount of profits earned by the wrongdoer. This form of relief differs from disgorgement, which takes away the profits earned by the wrongdoer rather than focuses on the damages sustained by his or her victims.

48 See note 38 at 3-4.

49 *Id.* at 17.

50 *Id.* (quoting *Texas Dept. of Housing & Community Affairs v. Inclusive Communities Project, Inc.*, 135 S. Ct. 2507, 2520 (2015)).

51 No. 19-507 (S. Ct. filed Oct. 18, 2019). Questions on appeal concern (1) whether a district court can award monetary relief under Section 13(b) of the FTC Act, consistent with separation-of-powers principles, and (2) whether a monetary disgorgement award under Section 13(b) of the FTC Act is a penalty and therefore outside a district court’s equity powers.

52 No. 19-508 (S. Ct. filed Oct. 18, 2019). Question on appeal concerns whether Section 13(b) of the FTC Act, through its authorization of injunctions, also authorizes the FTC to demand monetary relief, including restitution, and if so, what the scope of the limits or requirements are for such relief.

53 *Credit Bureau* (S. Ct. filed Nov. 8, 2019).

54 *Liu* (S. Ct. filed Jan. 20, 2020) at 3.

55 *Id.* at 4.

Conclusion

The *Kokesh* decision indirectly highlighted the often-discussed but never-contested issue of the SEC's ability to disgorge outside the context of an administrative proceeding. If in *Liu* the Supreme Court concludes that disgorgement is not within the SEC's statutory authority, then the SEC and FTC may likely urge Congress effectively to restore that power.

It is difficult to predict whether the SEC's and FTC's goals and objectives regarding deterrence and compensation will be significantly impacted by judicial challenges. An overwhelming number of cases are settled, which allows the agencies to enter into agreements with perpetrators to compensate victims, and perpetrators who are not required to admit wrongdoing have an increased incentive to settle to terms that may effectively require disgorgement to avoid admissions or findings of guilt. On the other hand, the government's bargaining power may be substantially undermined without the possibility of court-imposed disgorgement, or it may force the SEC to bring more actions administratively. The SEC's use of administrative proceedings itself has been under attack in recent years.⁵⁶ A further possible consequence is that whistleblowers may be less incentivized to report violations because the fund from which their award derives will be reduced if it is comprised of only penalties and not disgorgement.⁵⁷ Suffice it to say the decision in *Liu* has the potential to have far-reaching consequences beyond the authority of the SEC.

56 See e.g., Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, "Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices," at 14 (July 2019), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882_SEC_Reform_FIN1.pdf.

57 Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) (whistleblower awards are based on a percentage of the total monetary sanctions (e.g., civil penalties, disgorgement, interest) collected in the applicable enforcement action).