Securities
Regulation Daily

Wolters Kluwer

July 15, 2020

Supreme Court Upends SEC Disgorgement Remedy

By Antonia Apps, George S. Canellos, and Tawfiq Rangwala[1]

Introduction

In a decision that could have far-reaching effects on the ability of the Securities and Exchange Commission to remedy violations of the securities laws, the Supreme Court, in *Liu v. SEC*, No. 18–1501, rendered on June 22, curtailed the SEC's authority to obtain disgorgement of ill-gotten gains as a remedy in enforcement actions. The Court ruled that any award of disgorgement must be moored to traditional equitable doctrines. Drawing on precedents from the 19th century and earlier, the Court announced several limiting principles on the award of disgorgement and largely left to the lower courts the job of fleshing out those principles in individual cases.

While the *Liu* decision leaves many open questions, it puts in jeopardy the SEC's ability to obtain disgorgement in several common categories of cases. Among them are those lacking readily identifiable victims—such as insider trading cases, FCPA cases, and cases arising under rules for the general protection of markets and investors. In other cases, *Liu* may limit the amount of disgorgement to the net profits pocketed by the individual wrongdoer—gross revenues *minus* legitimate expenses. In reviewing the evolution of caselaw interpreting the scope of disgorgement in SEC cases, the Supreme Court clearly signaled its view that lower courts had not sufficiently checked the SEC's efforts to "test the bounds of equity practice." A broader influence of *Liu*, therefore, may be to encourage greater judicial scrutiny of litigation positions taken by the SEC, especially in shaping remedies.

Summary of Decision

Whereas the SEC is authorized by statute to seek "disgorgement" in administrative proceedings,[2] the corresponding statute governing civil proceedings in U.S. district courts authorizes "equitable relief" without express reference to disgorgement.[3] In *Kokesh* v. *SEC*, 581 U. S. ___ (2017), the Supreme Court unanimously determined that disgorgement is a "penalty" and thus subject to the statute of limitations governing SEC actions seeking penalties. *Kokesh* raised, but did not answer, the more fundamental question of "whether, and to what extent, the SEC may seek 'disgorgement' in the first instance [in U.S. district court] through its power to award 'equitable relief' under 15 U. S. C. §78u(d)(5)."[4] In a 8-1 decision authored by Justice Sotomayor, *Liu* answered this question:

1 Ms. Apps, Mr. Canellos, and Mr. Rangwala are litigation partners in Milbank LLP. Mr. Canellos previously served as Co-Director of the Enforcement Division of the Securities and Exchange Commission and Director of the SEC's New York Regional Office.

2 15 U. S. C. § 77h1(e).

3 15 U. S. C. § 78u(d)(5).

4 *Liu v. SEC*, 591 U. S. __, (slip op., at 1) (2020).

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for the benefit of victims qualifies as equitable relief.[5]

In so ruling, the Court opined that disgorgement in civil SEC actions is proper only where (1) disgorged funds are "for the benefit of investors" in accordance with the language in 15 U. S. C. § 78u(d)(5); (2) the award is based on "individual liability for wrongful profits" and not on the basis of joint and several liability where the party from whom disgorgement is sought did not engage in "concerted wrongdoing"; and (3) the award may not be "in excess of a defendant's net profits from wrongdoing" (*i.e.*, after expenses), unless all profits from a business or undertaking result from the wrongful conduct at issue, in which case "unconscionable" or "inequitable" deductions may be disallowed.[6]

In arriving at the above limitations, the Court followed the "equitable principle that the wrongdoer should not be punished by 'pay[ing] more than a fair compensation to the person wronged.'"[7] While the *Liu* Court did not directly hold that these limitations apply in SEC administrative proceedings—in which "disgorgement" is separately and expressly authorized by 15 U. S. C. § 77h1(e)—the Court wrote that disgorgement is inherently "a remedy grounded in equity [that] 'must, absent other indication, be deemed to contain the limitations . . . . equity typically imposes.'"[8] Indeed, the Court framed the reference to "disgorgement" in § 77h1(e) as simply granting this "equitable power[]"to the SEC.[9] Thus, the Court's reasoning strongly suggests that these limitations also apply in SEC administrative proceedings—with the possible exception of the "for the benefit of investors" requirement, which is based on statutory language in § 78u(d)(5).

With respect to the first limitation, the SEC had argued that "depriving wrongdoers of profits" denies "them the fruits of their ill-gotten gains . . . as a kind of restitution."[10] The Court disagreed and held that to qualify as an equitable remedy, disgorgement "must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains." The ill-gotten money should flow to victims (based on principles of equity), and, in district court cases, those victims must be "investors" (based on language in § 78u(d)(5)).[11] The Court stressed that "the Government has pointed to no analogous common-law remedy permitting a wrongdoer's profits to be withheld from a victim indefinitely without being disbursed to known victims."[12] The Court, however, left it to lower courts to consider how this principle should be given effect in cases where "the wrongdoer's profits cannot practically be disbursed to the victims."[13]

As to the second limitation, the Court warned that imposing "joint-and-several disgorgement liability" could "transform any equitable profits-focused remedy into a penalty."[14] Accordingly, an

---

5 *Id.*
6 *See id.* at __ (slip op., at 9, 11, 15, 1718)
7 *Id.* at __ (slip op., at 7) (quoting *Tilghman* v. *Proctor*, 125 U. S. 136, 145–146 (1888)) (alterations in original).
8 *Id.* at __ (slip op., at 14) (quoting *Great-West Life & Annuity Ins. Co.* v. *Knudson*, 534 U. S. 204, 211, n.1 (2002)).
9 *Id.* at __ (slip op., at 13).
10 *Id.* at __ (slip op., at 15).
11 *Id.* at __ (slip op., at 6, 16).
12 *Id.* at __ (slip op., at 15).
13 *Id.* at __ (slip op., at 17).
14 *Id.*

 ©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

obligation to pay disgorgement must be based on actual wrongdoing.[15] The Court recognized an exception, however, noting that "the common law did . . . permit liability for partners engaged in concerted wrongdoing." *Id.* In support of this proposition, the Court cited a nineteenth-century partnership law case, *Ambler v. Whipple*, 20 Wall. 546 (1874). *Ambler* involved a partnership for the purpose of developing and patenting an invention, in which a non-party to a profit-sharing agreement was nevertheless required to return profits improperly earned as a result of knowing participation in fraudulent conduct.[16]

The *Liu* opinion provided no concrete guidance on what relationships might constitute "partners engaged in concerted wrongdoing" in the securities-law context. As far as the petitioners were concerned, the Court noted that they were married, that Liu formed business entities from which he misappropriated investments and his spouse held herself out as a member of the management team of one such entity. The Court observed that petitioners "did not introduce evidence to suggest that one spouse was a mere passive recipient of profits," or that "one spouse did not enjoy the fruits of the scheme." But ultimately the Court left it "to the Ninth Circuit on remand to determine whether" the facts support a finding that the petitioners are "partners in [the] wrongdoing or whether individual liability is required."[17]

As to the third limitation, the Court held that the SEC must allow deductions for business expenses, with one major exception: that "when the 'entire profit of a business or undertaking" results from the wrongdoing, a defendant may be denied 'inequitable deductions' . . . ."[18] This exception requires courts to ascertain "whether expenses are legitimate or whether they are merely wrongful gains 'under another name.'"[19] Indeed, the word "profit" itself connotes a residual gain after the deduction of certain expenses. The Court pointed to two nineteenth-century precedents to illustrate the occasions when deductions should *not* be allowed. In *Goodyear*, the Supreme Court disallowed deductions of "extraordinary salaries" that "appeared merely to be 'dividends of profit under another name'" as well as the cost of "materials bought for the purposes of the infringement" (which the *Goodyear* Court distinguished from materials "acquired . . . to carry on the business," which *were* deductible).[20] In the second case, *Callaghan* v. *Myers*, the Court disallowed deduction of defendant's personal and living expenses from his profits from copyright violations.[21] Aside from these examples, however, the *Liu* Court declined to address all of "the various circumstances where a defendant's expenses might be considered wholly fraudulent."[22]

In dissent, Justice Thomas argued that "disgorgement" is not a traditional equitable remedy but rather a word used in a non-technical sense to describe the action a defendant must take when a party is awarded a traditional equitable remedy such as accounting for profits or equitable lien.[23] As a result,

---

15 *Id.* at __ (slip op., at 18).
16 *Ambler*, 20 Wall. at 559.
17 *Liu*, 591 U. S. at __ (slip op., at 18).
18 *Id.* at __ (slip op., at 19) (quoting *Root* v. *Railway Co.*, 105 U. S. 189, 203 (1882).
19 *Id.* at __ (slip op., at 19) (*Rubber Co. v. Goodyear*, 9 Wall. 788, 804 (1870)).
20 *Id.* at __ (slip op., at 10) (quoting *Goodyear*, 9 Wall. at 803).
21 128 U. S. 617, 663664 (1888).
22 *Id.*
23 *Id.* at __ (slip op., at 34) (Thomas, J. dissenting).

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

Justice Thomas would rule that disgorgement is not a remedy available under the statutory authority to grant "equitable relief." Justice Thomas also argued that the majority's expansive interpretation of what counts as equitable relief "threatens great mischief."[24] In particular, Justice Thomas criticized the majority for failing to provide clear guidance as to how lower courts should apply the limiting principles, including the majority's refusal to impose a blanket rule requiring disgorged funds to be returned to victims and not deposited in government coffers.[25] The concern that the Court may have left too much undecided appears reasonable in light of the decision's implications and the various open questions left to be addressed by future courts and litigants.

Implications

Because it imposes discipline in an area where the SEC had previously enjoyed considerable liberty, *Liu* is likely to constrain the SEC's (formerly tried-and-true) approach to seeking disgorgement in several types of cases commonly filed in district court—as well as administrative proceedings, to the extent that the limitations are based on principles of equity. For example:

Insider Trading

This ruling has important implications for disgorgement in the insider trading context, which the Supreme Court singled out for disapproval. In particular, the Court suggested that two existing principles in this area are no longer good law. In the first, those who trade on inside information for funds over which they have control (such as the investment manager of a hedge fund or mutual fund trading on behalf of the fund) have been required to disgorge not only profits they personally received for the illegal trading (such as a performance fee), but all of the profits the fund made from the trading.[26] In implicitly overruling the Second Circuit's 2014 ruling in *SEC v. Contorinis*, the Court brought the limits of disgorgement in line with the scope of criminal forfeiture, which only allows forfeiture of the actual gain to the defendant from the illegal trading.[27] Similarly, the *Liu* Court called into question the validity of cases holding tippers liable for the profits earned by tippees who trade on the tipper's inside information.

Foreign Corrupt Practices Act

In FCPA cases, courts routinely order disgorgement in approving settlements without requiring that such awards be distributed to wronged investors or considering whether any investors were harmed by the violation.[28] Now, the SEC must address whether investors were harmed and it appears that

---

24 *Id.* at __ (slip op., at 6) (Thomas, J. dissenting).

25 *Id.* at __ (slip op., at 1011) (Thomas, J. dissenting).

26 *See SEC* v. *Contorinis*, 743 F.3d 296, 302 (2d Cir. 2014).

27 *See U.S. v. Contorinis*, 692 F.3d 136, 148 (2d Cir. 2012).

28 *See, e.g.*, *SEC v. Ericsson*, No. 19 Civ. 11214, slip op. at 12, 4 (S.D.N.Y Dec. 20, 2019) (ordering distribution to Treasury of a $458,380,000 disgorgement award for bribing foreign officials to obtain business without assessing harm to investors); *see also SEC v. Teva Pharm. Indus. Ltd.*, No. 16 Civ. 25298, slip op. at 4 (S.D.N.Y. Dec. 29, 2016); *SEC v. Vimpelcom Ltd.*, No. 16 Civ. 1266, slip op. at 4 (S.D.N.Y. Feb. 22, 2016).

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

payments to Treasury will be suspect (if not wholly prohibited).[29] The SEC may find it impossible to meet this burden in the FCPA context because it is difficult to see how bribes to foreign officials harm specific investors, yet disgorgement (with payments to Treasury) is typically demanded by the SEC in these cases. Moreover, it is often unclear whether and to what extent the SEC has allowed for business expense deductions in FCPA settlements presented to district courts for approval. Going forward, entities facing FCPA charges will be well-positioned to aggressively push for a reduction of any disgorgement award by the amount of business expenses incurred by an otherwise legitimate entity that engaged in bribery of a foreign official or related books and records violations.

In SEC administrative proceedings involving FCPA violations, disgorgement has also been ordered without assessments of harm to victims.[30] Because *Liu* imposed those limitations on disgorgement based on principles of equity, it stands to reason that the limitations apply in administrative proceedings.

Market Manipulation

In market manipulation cases, courts often order disgorgement as part of a settled resolution without requiring that such awards be distributed to wronged investors or questioning whether the SEC has determined whether investors were harmed.[31] In this context, the SEC may well be able to identify specific investors who have suffered losses, but, henceforth, will need to exhaust efforts in this regard before considering whether any form of disgorgement to Treasury may be permissible.

Before *Liu*, courts also imposed liability for disgorgement in the market manipulation context (as well as other contexts) through joint-and-several liability.[32] *Liu* squarely rejects disgorgement on the basis of joint-and-several liability except where the SEC can establish that defendants were "partners" engaged in concerted wrongdoing. Therefore, to impose joint-and-several liability post-*Liu*, it appears that the SEC at least will have to show that each defendant either directly engaged in the wrongful conduct or knowingly aided in the wrongful conduct.[33] Although *Liu* did not discuss the

---

29 *See Liu*, 591 U. S. at __ (slip op., at 1516).

30 *See, e.g.*, *Novartis AG*, Release No. 89149 (June 25, 2020) (ordering disgorgement paid to the U.S. Treasury for making improper payments to healthcare providers in exchange for prescribing or using Novartis or Alcon products); *see also United Technologies Corp.*, Release No. 84087 (Sep. 12, 2018) (ordering disgorgement paid to the U.S. Treasury where the company's subsidiary bribed Azerbaijani officials to facilitate the sales of elevator equipment for public housing in Baku and sell elevators in China); *Sanofi*, Release No. 84017 (Sep. 4, 2018) (ordering disgorgement paid to the U.S. Treasury where the company's Kazakhstan and the Middle East subsidiaries bribed foreign officials); *Telia Company AB*, Release No. 81669 (Sep. 21, 2017) (ordering disgorgement paid to the U.S. Treasury for bribing Uzbek government officials); *Alcoa, Inc.*, Release No. 71261 (Jan. 9, 2014) (ordering disgorgement to be paid to the U.S. Treasury for bribing Bahraini officials to influence contract negotiations over a government-operated aluminum plant).

31 *See, e.g.*, *SEC v. Honig*, No. 18 Civ. 8175, 2020 WL 1150543, at *23 (S.D.N.Y. Mar. 6, 2020) (ordering distribution to Treasury of a $837,509.98 disgorgement award without assessing harm to investors from the violation at issue from defendants' "pump and dump" scheme involving artificially boosting the stock price of three companies and then selling their shares in the inflated market).

32 *See, e.g.*, *SEC v. Lek Securities Corp.*, No. 17 Civ. 1789, 2020 WL 1316911 at *1, 3 (Mar. 20, 2020) (ordering disgorgement, jointly and severally, where defendants were found to be "collaborating or closely related parties" with respect to Exchange Act § 10(b), Rules 10b-5(a), (c), and Securities Act §§ 17(a)(1), (a)(3) violations for layering and cross-market manipulation)

33 *See Liu*, 591 U. S. at __ (slip op., at 18).

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

mens rea required to establish joint-and-several liability, the limitation of such liability to "partners" engaged in "concerted wrongdoing" suggests that it would apply only to persons consciously engaged in joint misconduct. Thus, *Liu* may entirely foreclose the imposition of joint-and-several liability in negligence-based cases, including those arising under Section 206(2)-(4) of the Investment Advisers Act, Section 17(a)(2) and (3) of the Securities Act of 1933, and for "causing" violations subject to the cease-and-desist provisions of all of the securities acts. Such cases make up a broad cross-section of the SEC's enforcement docket.

Rules for the General Protection of Markets and Investors

A significant percentage of the SEC's enforcement actions are for violations of statutes and rules adopted for the general protection of markets and investors, such as rules requiring registration of broker-dealers, investment advisers, and other financial market participants, rules regulating short-selling and other trading and order activity, rules requiring broker-dealers to segregate their customers' assets and to maintain minimum net capital levels, and rules requiring reporting of information about beneficial ownership of securities and other potentially material information. In many of these cases, the SEC and Courts have ordered disgorgement of very significant sums to the Treasury despite the absence of any readily discernible victim. Thus, for example, the SEC obtained in *SEC v. UBS AG*, a disgorgement award of $200,984,065 from UBS for acting as an unregistered broker-dealer and investment advisor; obtained in *SEC v. Teo*, a disgorgement award of $17,422,054.13 from Teo and MAAA Trust (jointly and severally) for misrepresenting Teo's beneficial ownership of Musicland shares; and ordered, in *In the Matter of Merrill Lynch*, Merrill Lynch and Merrill Lynch Professional Clearing Corp. to disgorge of proceeds of $50,000,000 (jointly and severally) for improperly profiting off the investment of cash required to be segregated in a customer reserve account.[34] In many of these cases, courts have also disallowed deductions for legitimate business expenses in assessing the amount of disgorgement awards.[35]

Now, the SEC must first assess whether the award of disgorgement fits within a traditional equitable framework, then determine whether any business expenses are profits by another name or otherwise inequitable, which the SEC may be able to disallow only if "all profits from the undertaking" resulted from the violations, or otherwise do the work of deducting business expenses and limiting any disgorgement demand to the net profits earned by the defendant. The SEC will also need to show how the violations harmed specific investors, which may prove impossible. For example, in *SEC v. UBS AG*, the only victim was the Internal Revenue Service and, in *SEC v. Teo*, Teo's wrongful conduct arguably harmed the company itself, rather than any specific investors therein. [36]

---

34 *SEC v. UBS AG*, 9 Civ. 316, slip op at 2 (D.D.C. Sept. 23, 2010); *SEC v. Teo*, 746 F.3d 90, 107, 109 (3d Cir. 2014); *In the Matter of Merrill Lynch*, Release No. 78141 (June 23, 2016).

35 *See, e.g., SEC v. Verdiramo*, 907 F.Supp.2d 367, 375 (S.D.N.Y. 2012) (holding that "general business expenses may not be subtracted from the disgorgement amount").

36 *SEC v. UBS AG*, 9 Civ. 316; *SEC v. Teo*, 746 F.3d at 109 (explaining that Teo's violation "insulated the valuation of" his "holdings from the effects of a poison pill that could have been activated" if the company had known of his beneficial ownership).

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

For reasons Justice Thomas forecast in his dissent, the long-term implications of *Liu* will take time to come into focus as courts grapple with the enormously consequential questions left open by the Court. The most pressing questions that may be litigated include:

- Because the language "for the benefit of investors" comes from statutory language in 15 U. S. C. §78u(d)(5), which governs *district court* actions, can the SEC in *administrative proceedings* collect disgorgement for the benefit of a broader class of victims who are *not* investors? As previously discussed, the SEC's authority under 15 U.S.C. §77h–1(e) to order disgorgement in administrative cease-and-desist proceedings is not expressly required to be exercised "for the benefit of investors." And, indeed, are there non-investor "victims" of securities law violations who may have been wronged and who could be compensated consistent with equitable principles?

- In light of the underlying reasoning in *Liu*, is disgorgement ever appropriate for victimless violations or those in which specific investor-victims cannot be readily identified? The *Liu* Court repeatedly stressed the need to conform disgorgement to "common-law limitations" and to fit the remedy within "the bounds of traditional equitable principles."[37] The Court also suggested that restoring profits to their rightful owner was the inherent objective of disgorgement, stated that the "equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to the wronged investors for their benefit."[38] These potential limitations on the award of disgorgement in cases lacking a discernible victim should apply equally in district court and administrative proceedings and likely foreclose disgorgement in many classes of cases.

- How hard must the SEC try to identify wronged investors? And, ultimately, is there any case in which equity allows for ill-gotten gains to be distributed to Treasury? While the Court left open the question of whether disgorgement may be retained by the Treasury if the wrongdoer's profits "cannot practically be disbursed to the victims," the Court did not hint at what practical impediments might justify the government's retention of a disgorgement award.[39] The Court also did not indicate whether disgorgement might be permissible even if the SEC made no effort to compensate the victim—or had no particular victim in mind—as distinguished from circumstances in which the SEC has exhausted efforts to compensate an intended beneficiary.

- If the bulk of a disgorgement award is used to return ill-gotten gains to investors, can a portion of the award—before victims are fully compensated—still be deposited into the Treasury fund established by the Dodd-Frank Act, and used (consistent with the Act) to fund awards to whistleblowers and the activities of the SEC's Inspector General?[40] If so, how much can be withheld from the case-specific victims before running afoul of equitable principles?

- When does the exception for "partners engaged in concerted wrongdoing" apply to authorize joint-and-several disgorgement? Does this exception apply only to formal or informal

37 *Liu*, 591 U. S. at __ (slip op., at 12).
38 *Id.* at __ (slip op., at 15).
39 *See Id.* at __ (slip op., at 17).
40 *See* 124 Stat. 1844.

 ©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

partnerships involving the sharing of revenues and expenses of an illegal business venture? Or is it applicable whenever there is an *agreement* among codefendants to engage in conduct that violates the securities laws (analogous to a "conspiracy" in criminal law)? If an agreement were all that it takes, how would the exception avoid swallowing the rule? And how could it be squared with the Court's emphasis on restricting the remedy to "an individual wrongdoer's net profits" in order to "avoid transforming the remedy into a punitive sanction"?

- As noted above, the Court suggests that disgorgement awards should be limited to "net profits," defined as "the gain made upon any business, or investment, when both the receipts and payments are taken into account," except when "the entire profit of a business or undertaking results from wrongful activity."[41] Does the fact that a business (such as a broker-dealer or accounting firm) makes legitimate profits that are unrelated to a violation automatically preclude a finding that the "entire profit of a business or undertaking" results from wrongdoing? Or can "wrongdoing" be considered a separate "undertaking," the entire profits of which result from wrongdoing? Would courts need to engage in an assessment of the percentage of a business that is involved in wrongdoing to determine whether it can fairly be said that the entire profits of the business are tied to wrongdoing?

Conclusion

Although *Liu* upheld the SEC's fundamental authority to seek disgorgement of ill-gotten gains from securities law violators, it disrupts longstanding practices for computing the amount of disgorgement awards and cabins or eliminates the SEC's authority to obtain disgorgement in many common classes of cases. The many open questions posed by *Liu* can only be answered through case-by-case development in the lower courts. Together with *Kokesh*, the decision represents a significant setback in the SEC's successful efforts, through legislation and litigation over the course of more than three decades, to obtain greater and more flexible remedies, in multiple forums, for violations of the federal securities laws. Perhaps most remarkably, the case—which was accepted for certiorari without any split of Circuit Court authorities—reflects unanimous disagreement of the nine current justices of Supreme Court with the approach to disgorgement generally followed by lower courts. The decision also comes at a time of significant public debate about the authority and influence of independent administrative agencies. The decision thus may encourage not only close examination by the lower courts of the open questions posed by *Liu* but also other aspects of the SEC's litigation and enforcement program.

* * *

Milbank associates Jacob Jou and Christopher Almon contributed to this article. The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

---

41 *Liu*, 591 U. S. at __ (slip op., at 10-11).

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.