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Securities Regulation Daily Wrap Up, TOP STORY—U.S.: Disgorgement not exceeding amount of net profits is permissible equitable relief, (Jun. 22, 2020)

Securities Regulation Daily Wrap Up

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By Rodney F. Tonkovic, J.D.

The Supreme Court upheld the SEC's ability to seek disgorgement in civil proceedings as a form of equitable relief, so long as the award is limited to the net profits of the wrongdoer and funds go to victims.

Answering a question left open in *Kokesh v. SEC,* the Supreme Court held that a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is permissible equitable relief. Writing for the Court in *Liu v. SEC*, Justice Sotomayor said that equity practices have long authorized stripping wrongdoers of ill-gotten gains and that Congress incorporated these longstanding equitable principles into Exchange Act Section 21(d)(5), thus prohibiting the Commission from seeking an equitable remedy in excess of the net profits from the wrongdoing. The Ninth Circuit's judgment is accordingly vacated, and the case is remanded for proceedings consistent with the opinion. In dissent, Justice Thomas argued that disgorgement is not a traditional equitable remedy and can never be awarded under Section 21(d)(5) (*Liu v. SEC*, June 22, 2020, Sotomayor, S.).

Origins of disgorgement. Under Exchange Act Section 21(d)(5) (15 U.S.C. §78u(d)(5)), the SEC can seek "equitable relief" before a federal court. Since Congress did not define "equitable relief," courts have had to determine what this means, and, since the 1970s, have found that the SEC could obtain what was originally called "restitution," that is, depriving a defendant of the gains of wrongful conduct. This remedy, Justice Sotomayor noted, has more recently been referred to as disgorgement (a distinction also noted by Justice Thomas in his dissent).

In *Kokesh*, the Court held that the disgorgement often sought by the SEC in enforcement cases is a penalty for purposes of the five-year statute of limitations contained in 28 U.S.C. §2462 (covering civil fines, penalties, or forfeitures). The holding in *Kokesh* was a narrow one, and the Court did not address whether a penalty under §2462 could still qualify as equitable relief under Section 21(d)(5), and explicitly said that it was not opining on the authority of federal courts to order disgorgement in SEC enforcement proceedings.

The case against Liu. In this case, two defendants in a civil enforcement action challenged a district court's order that they disgorge almost $27 million raised from investors in an EB-5 fraud scheme. The Ninth Circuit, in an unpublished decision, affirmed, explaining that Kokesh left the question of federal courts' authority to award disgorgement for another day, so that case was not, as the defendants argued, irreconcilable with longstanding Ninth Circuit precedent. The circuit panel rejected Liu's argument that the disgorgement award failed to account for business expenses as "unjust" under circuit precedent and held that the proper amount of disgorgement is "the entire amount raised less the money paid back to the investors."

The petition. The Supreme Court granted certiorari in Liu v. SEC (18-1501) on November 1, 2019, for a petition asking whether the SEC may seek and obtain disgorgement from a court as "equitable relief" for a securities law violation in light of the Court’s ruling in Kokesh that such disgorgement is a penalty. The petition argued that Congress authorized the Commission to seek only injunctions, civil monetary penalties, and equitable relief. Applying the reasoning behind Kokesh, if disgorgement is a penalty, it falls outside the scope of equitable relief and thus lacks any statutory authority.

A long history of profits-based remedies. In Liu, the question of whether courts possess authority to order disgorgement in SEC enforcement proceedings was now squarely before the Court. At the outset, Justice Sotomayor undertook the "familiar" task of analyzing whether a particular remedy falls into the categories of relief that were typically available in equity. She noted that equity practices have long authorized (under various labels) stripping wrongdoers of ill-gotten gains and that courts, in order to avoid transforming an equitable remedy into a penalty, have restricted the remedy to awarding a wrongdoer's net profits to the victims.

According to Justice Sotomayor, Congress incorporated these longstanding equitable principles into Section 21(d)(5), thus prohibiting the Commission from seeking an equitable remedy in excess of the net profits from the wrongdoing. Over the years, however, courts have awarded disgorgement in ways that are in tension with equity practice: ordering the proceeds of fraud to be deposited in Treasury funds; imposing joint-and-several-liability; and by declining to deduct legitimate expenses from the receipts of the fraud. While the Commission maintained that a more expansive interpretation of the equitable disgorgement remedy has the tacit support of Congress, Justice Sotomayor said, however, that even if Congress used the term "disgorgement" as a sort of shorthand reference to Section 21(d)(5) in other statutes, this does not "silently rewrite the scope of what the SEC could recover in a way that would contravene limitations embedded in the statute," that is, a defendant's net profits.

Guidance for lower courts. 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 Section 21(d)(5). Applying these principles to this case, the petitioner argued that their disgorgement award was unlawful under traditional equity practice because it: failed to return funds to the victims; imposed joint-and-several liability; and failed to deduct business expenses from the award. Because the parties focused on the broad question of whether any form of disgorgement may be ordered, Justice Sotomayor addressed these issues briefly in order to provide guidance on remand.

First, the equitable nature of the profits remedy generally requires the return of a defendant's gains to benefit the victims. In this case the SEC did not return the bulk of the funds to the victims due to an inability to collect them, and, suggested that the practice of depositing disgorgement funds with the Treasury may be justified where it is not feasible to distribute the funds to investors. In any event, there was no specific order directing any proceeds to the Treasury, and, if one is entered on remand, the lower courts may evaluate whether that order would be for the benefit of investors under Section 21(d)(5).

Next, Justice Sotomayor said that imposing joint-and-several liability runs against the rule in favor of holding defendants individually liable. But, she continued, the common law did permit liability for partners engaged in concerted wrongdoing. On remand, then, the Ninth Circuit should determine whether the petitioner’s, who were married, can be found liable for profits as partners in wrongdoing or if individual liability is required.

Finally, courts must deduct legitimate business expenses before awarding disgorgement. In this case, the district court declined to deduct Liu's business expenses on the theory that they were incurred to further the fraudulent scheme. Some of Liu's expenses went toward lease payments and cancer-treatment equipment that could have value independent of the scheme, so the question becomes whether those expenses are legitimate or wrongful gains "under another name." The lower court should examine whether including those expenses in a profits-based remedy is consistent with the equitable principles underlying Section 21(d)(5), Justice Sotomayor said.

Dissent. Justice Thomas dissented, agreeing with the Court's declining to affirm the Ninth Circuit's decision, but taking issue with the decision to vacate and remand, saying that he would reverse the judgment. According to Justice Thomas, disgorgement is not a traditional equitable remedy and can never be awarded under Section 21(d)(5). He maintains that disgorgement is a 20th-century invention and has no basis in historical practice as a traditional form of equitable relief. The dissent notes further that prior to 2005, the SEC lacked the power to seek equitable relief in cases like this one and that disgorgement is a judicially-created remedy. If the majority accepts disgorgement as an available remedy, Justice Thomas concludes, it should at least limit the order to be consistent with traditional equity. That is, the order should be limited to each petitioner’s profits, it should not be imposed jointly and severally, and the money paid by the petitioners should be used to compensate their victims.

What's next? The opinion in Liu affects two petitions asking essentially the same question that have been pending awaiting the outcome in this case. Having addressed the issue, the Court is likely to issue orders in the near future denying certiorari or granting, vacating, and remanding consistent with the holding in Liu.

- Team Resources v. SEC (19-978) asks whether the SEC may obtain disgorgement from a federal court as an equitable remedy for securities violations despite the Supreme Court's determination in Kokesh that disgorgement is a penalty. The petitioners recognized that the Court granted the petition in Liu v. SEC asking the same question, and both parties agreed that the petition be held pending the decision in Liu
- Next, Jalbert v. SEC (19-1310) asks whether a federal government agency's order imposing unauthorized penalties labeled "disgorgement" is void in relevant respects because the agency did not have the power to impose penalties without explicit congressional authorization (the petition separately frames the same question in terms of a separation of powers violation). A key difference in this case, however, is the fact that the petitioner waived the right to judicial review of the SEC order at issue as part of a settlement, leading to the First Circuit's affirming the district court's dismissal on those grounds.

Finally, Congress has also advanced legislation that would clarify, once and for all, the SEC's authority to seek, and for a federal court to order, disgorgement. The House version of the bill would allow a 14 year limitations period on disgorgement, while the Senate version retains the 5-year limitations period in 28 U.S.C. §2462. Moreover, the Senate version would grant the SEC authority to seek restitution in addition to disgorgement, which the House version does not mention. The House passed its version in November 2019, but the Senate version remains in committee.

The case is No. 18-1501.

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