Simpson Thacher

"The Court holds today that a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under §78u(d)(5)."

– Justice Sotomayor

Report from Washington

Supreme Court Affirms SEC's Disgorgement Remedy, but Places Limits on Its Use

June 23, 2020

On June 22, 2020, in *Liu v. SEC*, No. 18–1501, the Supreme Court resolved the question it raised but left open just a few years ago in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017): whether the SEC is authorized to seek disgorgement in federal court proceedings. In an 8-1 decision, the Court upheld but circumscribed the SEC's ability to seek disgorgement. Specifically, the Court held that disgorgement constitutes permissible "equitable relief" under 15 U.S.C. § 78u(d)(5), but only where disgorgement is based on *net* profits and ordinarily where disgorged funds are distributed to victims.

Some of the practical takeaways of this decision are as follows:

- These limitations are likely to significantly reduce the amount of disgorgement the SEC can obtain.
- The requirement that disgorgement be based on net profits will likely lead to involved settlement discussions over how to calculate legitimate business expenses and profits.
- The requirement that disgorgement be paid to victims could be especially impactful in FCPA and insider trading cases, although the Court left open the possibility that disgorgement need not be distributed where not feasible. However, with the diminished ability to seek disgorgement, the SEC may look to seek higher penalties in such cases.
- Still to be decided is the question whether the limitations on the SEC's ability to seek disgorgement in federal court will also apply to the SEC's ability to seek disgorgement in administrative proceedings.

Summary

When the SEC brings enforcement actions in federal court, it is authorized by statute to seek a range of remedies, including "any equitable relief that may be appropriate or necessary for the benefit of investors." In *Kokesh*, the Court held that disgorgement of profits is a "penalty" for the purposes of statutes of limitations. However, the *Kokesh* Court explained in a footnote that "[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context." In *Liu*, on the heels of *Kokesh*, the petitioners argued that disgorgement was not an equitable remedy, and therefore, not within the statutory authorization.

"Over the years, however, courts have occasionally awarded disgorgement in three main ways that test the bounds of equity practice: by ordering the proceeds of fraud to be deposited in Treasury funds instead of disbursing them to victims, imposing joint-and-several disgorgement liability, and declining to deduct even legitimate expenses from the receipts of fraud. The SEC's disgorgement remedy in such incarnations is in considerable tension with equity practices."

– Justice Sotomayor

Although the briefing in *Liu* focused on the all-or-nothing question of whether the SEC could seek (and courts have the power to order) disgorgement in federal court proceedings, the oral argument focused instead on what aspects of a disgorgement award might make it punitive instead of equitable. The Justices asked petitioners' counsel if the disgorgement in the case would have been equitable if it were returned to investors (instead of turned over to the U.S. Treasury) and seemed focused on how the SEC calculates disgorgement awards, foreshadowing the focus of the Court's decision this week.

While petitioners argued that disgorgement is not "equitable relief" within the meaning of 15 U.S.C. § 78u(d)(5), Justice Sotomayor, writing on behalf of the Court, said: "Not so." The Court held that a disgorgement award is proper so long as it (1) does not exceed the wrongdoer's net profits, and (2) in the ordinary case, is given to victims of the wrongdoing. The Court further questioned the practice of imposing the disgorgement remedy on a joint-and-several basis.

The Court observed that equity practice has historically allowed courts to deprive wrongdoers of ill-gotten gains and that these remedies are equitable (instead of punitive) so long as they are restricted to net profits and awarded to victims. In light of this history, the Court held the SEC is well within its statutory authority to seek disgorgement in civil suits. The Court declined to extend *Kokesh*'s conclusion that disgorgement is a penalty beyond the statute of limitations context, noting that "that decision has no bearing on the SEC's ability to conform future requests for a defendant's profits to the limits outlined in common-law cases awarding a wrongdoer's net gains." The Court did acknowledge three trends in the SEC's use of the disgorgement remedy that might not comport with a traditional equitable remedy.

"To be sure, the Kokesh *Court evaluated a version of the SEC's disgorgement remedy that seemed to exceed the bounds of traditional equitable principles. But that decision has no bearing on the SEC's ability to conform future requests for a defendant's profits to the limits outlined in common-law cases awarding a wrongdoer's net gains."*

– Justice Sotomayor

First, the Court questioned the practice of depositing disgorgement awards into the U.S. Treasury, noting that § 78u(d)(5) authorizes equitable relief "for the benefit of investors." The Court explained that the equitable nature of the profits remedy would ordinarily require the SEC to return profits to wronged investors, not the Treasury. The Court allowed that the SEC might be able to send disgorgement awards to the Treasury when it is not feasible to distribute funds to the investors, but noted that this issue was not before the Court.

Second, the Court expressed concern about the SEC's practice of seeking joint-and-several liability for disgorgement awards, stating: "That practice could transform any equitable profits-focused remedy into a penalty," especially if the SEC sought to disgorge from one defendant profits earned by another defendant. The Court explained that joint-and-several liability might be appropriate in cases of concerted wrongdoing and shared profits (e.g., by partners in a partnership), but that lower courts would have to assess the facts in each case to see if equitable principles permitted such an award.

Third, the Court explained that courts must deduct legitimate business expenses from disgorgement awards. This shifts the focus from gross profits to net profits. The Court explained that courts should not deduct illegitimate personal expenses, but that ordinarily defendants should not be required to disgorge funds they spent on business expenses. The Court also acknowledged that in rare cases where the defendant's entire enterprise was fraudulent, then no business expenses would be legitimate and gross profits would be the correct measure of disgorgement.

Justice Thomas dissented, writing that he would hold that disgorgement is not an "equitable remedy" within the meaning of 15 U.S.C. §78u(d)(5) and would have reversed the opinion of the Ninth Circuit.

Implications

Although the *Liu* opinion affirmed the SEC's ability to seek disgorgement in civil suits, the case introduces serious limits on how the SEC can pursue that remedy.

The Court's instruction that disgorgement be limited to net profits could reduce SEC disgorgement awards. In some cases, defendants might have spent a considerable amount of funds on legitimate business expenses, greatly reducing the net disgorgement award. We would expect SEC investigative staff to closely scrutinize claimed business expenses for legitimacy.

The SEC obtains billions of dollars in disgorgement every year, requiring defendants in civil securities suits to disgorge the ill-gotten gains of their misconduct. In 2019, the SEC obtained $3.2 billion in disgorgement, compared with $1.1 billion in civil penalties. We may see a shift in that ratio going forward, as the SEC may greet limitations on the disgorgement remedy with efforts to ratchet up penalties.

The Court's opinion also puts more pressure on the SEC to return disgorged funds. In 2019 the SEC returned 37% of $3.2 billion in disgorged funds to investors. Going forward, the Commission will focus even more intently on connecting investors with disgorged funds.

A question is also raised, as pointed out in Justice Thomas's dissent, as to whether these newly prescribed limits on the scope and nature of disgorgement will apply in administrative proceedings—where disgorgement is expressly provided for by statute—given that the reasoning for those limits is anchored in the common law. Nonetheless, since the disgorgement remedy in administrative proceedings has always been thought to mirror the disgorgement remedy that could be imposed under traditional equitable principles in district court, we would not expect a divergence in approach. Moreover, simply as a practical matter, given how clearly the Court spoke in *Liu*, and in light of the criticism the Commission has absorbed over the perceived unfairness of litigating in the administrative forum, ignoring *Liu* in administrative proceedings would likely ignite another round of litigation and criticism over the SEC's administrative process.

Finally, the *Liu* decision comes amid pending bipartisan legislation to grant the SEC express authority to seek disgorgement in federal court proceedings and to lengthen the statute of limitations for disgorgement claims to 14 years. Whether or not the Court's holding in *Liu* takes the urgency out of these legislative efforts remains to be seen.

For further information, please contact one of the following members of the Firm's Litigation Department.

NEW YORK

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

Paul C. Curnin
+1-212-455-2519
pcurnin@stblaw.com

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

Susannah Geltman
+1-212-455-2762
sgeltman@stblaw.com

Paul C. Gluckow
+1-212-455-2653
pgluckow@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Peter E. Kazanoff
+1-212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Joseph M. McLaughlin
+1-212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Michael J. Osnato
+1-212-455-3252
michael.osnato@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

Jonathan K. Youngwood
+1-212-455-3539
jyoungwood@stblaw.com

WASHINGTON, D.C.

Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

Meaghan A. Kelly
+1-202-636-5542
mkelly@stblaw.com

Diana C. Wielocha
+1-202-636-5514
dwielocha@stblaw.com

Adrienne V. Baxley
+1-202-636-5503
adrienne.baxley@stblaw.com

M Moore*
+1-202-636-5822
m.moore@stblaw.com
**Not Yet Admitted*

PALO ALTO

James G. Kreissman
+1-650-251-5080
jkreissman@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000