LIU V. SEC: THE SUPREME COURT LIMITS THE SEC'S DISGORGEMENT POWER AND SETS THE STAGE FOR FUTURE LEGAL BATTLES

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On 22 June 2020, in a much anticipated decision, the Supreme Court held that the Securities and Exchange Commission (SEC or the Commission) can continue its longstanding practice of seeking disgorgement as an equitable remedy in judicial proceedings under Section 21(d) of the Securities Exchange Act of 1934. In *Liu*, the Court held that a disgorgement award that (1) does not exceed a wrongdoer's net profits, and (2) is awarded for victims, constitutes an equitable remedy within the scope of the SEC's statutory authority.1 In so holding, the Court made clear that legitimate business expenses must be accounted for in determining how much the SEC can seek in disgorgement. Though the Court indicated its skepticism toward the SEC's longstanding practice of sending disgorged funds to the Treasury, it did not specifically address whether disgorged funds must be returned to victims of the misconduct being prosecuted, leaving that determination to the lower courts.[2] The Court also left unanswered whether the SEC is authorized to impose joint and several liability on violators.[3] Following *Kokesh* and other recent decisions, this is the Supreme Court's latest decision to rein in the SEC's enforcement authority. While Liu stopped short of eliminating the power of the SEC to seek disgorgement for securities law violations, it provided companies facing SEC enforcement scrutiny with the necessary tools for challenging and circumscribing the amount sought by the Commission. While this decision provides some clarity on the parameters of the SEC's authority, it leaves open many questions that will be resolved in future settlement negotiations and court battles.

THE COURT'S HOLDING

The *Liu* decision was eagerly anticipated by SEC defense counsel and regulated entities. The potential impact on SEC enforcement action if disgorgement were eliminated as an equitable remedy would have been game-changing, but instead of providing absolute clarity in either direction, the Supreme Court stopped short. In doing so, it raised more questions that may give rise to potential future challenges. Writing for an 8-1 majority, Justice Sotomayor rejected an all-or-nothing approach to the question of whether disgorgement constitutes a permissible equitable remedy. The Court held that a disgorgement award which, (1) does not exceed a wrongdoer's net profits, and (2) is awarded for victims, constitutes equitable relief the SEC is permitted to seek in enforcement actions.[4] To arrive at this holding, the Court examined whether the disgorgement sought in *Liu*—which required the defendants, a married couple, to disgorge the full amount they raised from defrauded investors, without any reduction for their claimed business expenses, and which imposed joint-and-several liability on the two spouses—falls into “those categories of relief that were *typically* available in equity.”[5] The Court examined cases in which courts imposed “profits-based remedies” while placing limitations on those remedies that ensured they did not constitute penalties beyond the scope of a court's equitable powers.[6]

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THE FUTURE OF DISGORGEMENT POST-LIU

In limiting disgorgement to a violator's net profits, the Court provided guidance regarding how to differentiate valid expenses for future disgorgement calculations. The majority opinion draws a line between legitimate business expenses and those that are "wholly fraudulent" in furtherance of a scheme to defraud investors.[7] While the Court left it to the lower court on remand to assess the legitimacy of the expenses in question, the Court seemed to indicate the potential legitimacy of certain expenses at issue in *Liu* because they "arguably have value independent of fueling a fraudulent scheme."[8]

In what will likely set the stage for future battles both during settlement discussions and in the courtroom, the Court declined to answer whether the SEC's longstanding practice of sending disgorgement funds to the Treasury rather than to victims or harmed investors would be permissible under its new disgorgement limitations.[9] The Court also declined to address whether imposing joint-and-several liability against violators was within the SEC's statutory authority.[10] Both of these questions will cause future questions, and provide points of argument in upcoming SEC enforcement actions. While not conclusive, *Liu* provided some indication of the Court's skepticism toward both practices that will help entities and individuals facing SEC enforcement scrutiny going forward. In addressing the issue of improperly earned profits under equitable principles, the Court noted that "the SEC's equitable, profits-based remedy must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains. To hold otherwise would render meaningless the latter part of §78u(d)(5)."[11] The Court emphasized that no order in *Liu* required funds be directed to the Treasury, but that, if such an order were to be entered on remand, the lower courts may evaluate whether that order would be "for the benefit of investors" and therefore within the SEC's statutory grant of authority and in accordance with equitable principles.[12] Similarly, the Court concluded that disgorgement is inappropriate where it includes the ill-gotten gains that accrue to affiliates through a joint-and-several liability theory.[13] Instead, the Court opted to instruct the 9th Circuit to determine whether the petitioners could be found liable "for profits as partners" or whether individual liability is appropriate.[14] This latter point will also set the stage for future battles between co-defendants, individuals, and entities seeking to limit their own damages or disprove a joint venture or partnership in the underlying misconduct.

WHAT IT MEANS FOR REGULATED ENTITIES AND INDIVIDUALS

As SEC-regulated entities around the country await the outcomes of future legal battles, companies and individuals should expect the SEC to continue to seek disgorgement under familiar theories pre-*Liu*. Over the past five years, disgorgement has accounted for approximately 71 percent of the SEC's monetary recoveries.[15] Absent a change in enforcement strategy or more stringent restrictions imposed by courts around the country—neither of which is expected—the Commission's efforts will continue. Savvy regulated entities should nonetheless be prepared to push back on Commission overreach using the tools the Court has given them. To do so, companies and individuals subject to SEC scrutiny should take steps to anticipate how they might use the findings of the Supreme Court in *Liu* (and other decisions like *Kokesh*) to their advantage. While we await the reactions to this decision in the lower courts, the best practices for companies to consider today—before facing SEC scrutiny tomorrow—include:

- Understanding relationships with employees, joint venture partners, agents, and other affiliated entities that could impact future joint and several liability.

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- Ensuring that you have a proper understanding of the accounting issues at play in the business under review.
- Understanding all expenses relevant to the conduct at issue, and those expenses' relationship to business operations outside of the allegedly improper scheme. Be prepared to justify those expenses to avoid paying them in disgorgement later.
- Keeping up to date on the lower court reactions to the *Liu* decision, and seeking advice from experienced counsel when questions arise.

FOOTNOTES

[1] *Liu v. Sec. & Exch. Comm'n,* No. 18-1501, 2020 WL 3405845, at *2 (U.S. June 22, 2020).

[2] *See id.* at *9.

[3] *See id.*

[4] *Liu* at *2.

[5] *See id.* at *5 (emphasis in original).

[6] *See id.* at *5–*8.

[7] *Id*. at *11.

[8] *See id.* at *12 (“[S]ome expenses from petitioners' scheme went toward lease payments and cancer-treatment equipment. Such items arguably have value independent of fueling a fraudulent scheme.”)

[9] *See id.* at *9.

[10] *See id.*

[11] *Id*. at *10.

[12] *Id*.

[13] *See id*. at *11.

[14] *Id*.

[15] *See* SEC DIV. OF ENF'T, DIVISION OF ENFORCEMENT 2019 ANNUAL REPORT 16.

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