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US Supreme Court Upholds SEC's Authority to Seek Disgorgement

Questions about the scope of the SEC's disgorgement authority remain open, including in administrative proceedings.

Key Points:

- Since the April 2017 decision in *Kokesh v. SEC*, the statutory authority of the Securities and Exchange Commission (SEC or Commission) to seek disgorgement in civil enforcement proceedings has been an open question.
- On June 22, 2020, in *Liu v. SEC,* the Supreme Court upheld the SEC's statutory authority to pursue disgorgement as "equitable relief" in federal court under 15 U.S.C. § 78u(d)(5). The Court held that disgorgement is an equitable remedy where it is restricted to an individual wrongdoer's net profits and is awarded to victims. However, in remanding the case to the lower courts to craft a more limited disgorgement order, the decision left open key questions regarding the scope and contours of the SEC's disgorgement authority.
- *Liu* also left unresolved whether the Court's restrictions on disgorgement will apply to SEC administrative proceedings or other federal agencies.

Background: The *Kokesh* Uncertainty

Since first obtaining disgorgement almost a half century ago, the SEC has routinely sought disgorgement of ill-gotten gains, and courts have routinely imposed it. Disgorgement continues to be an important remedy for the SEC. In fiscal year 2019, the SEC obtained US$3.248 billion in disgorgement. As previewed in Latham's *2019 Client Alert*, the stage was set for the *Liu* decision with *Kokesh v. SEC*,[1] in which the Supreme Court held that a disgorgement order in an SEC enforcement action constituted a "penalty" for the purposes of 28 U.S.C. § 2462, which governs statutes of limitations. While a significant decision in its own right, as discussed in Latham's *2017 Client Alert*, *Kokesh* was also noteworthy for what it did *not* decide: namely whether disgorgement, a common feature of SEC enforcement actions, would survive and in what form.

In a much discussed footnote in *Kokesh*, the Court expressly declined to rule "on whether courts possess authority to order disgorgement in SEC enforcement actions in federal court or on whether courts have properly applied disgorgement principles in this context."[2] After *Kokesh*, no federal court decided to overturn the Commission's disgorgement authority, but several noted that the SEC's disgorgement authority was on unsteady ground, setting the stage for the challenge in *Liu*.[3]

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The *Liu* Litigation

In 2016, the SEC alleged that Charles Liu and Xin Wang fraudulently diverted funds raised from foreign investors — purportedly to build a cancer treatment center in California — for their personal use and to solicit new investors. After finding that Liu and Wang's scheme violated federal securities laws, the court ordered them to disgorge more than US$26 million — the total amount of funds they had raised from investors. Liu and Wang argued that this disgorgement award failed to account for their "legitimate" business expenses in setting up the cancer center. The district court disagreed, concluding that the sum was a "reasonable approximation of the profits causally connected to [their] violation."[4]

Liu and Wang appealed and argued that the SEC did not have authority to seek disgorgement in a federal court under *Kokesh* because disgorgement was a penalty and thus not a form of "equitable relief" that is permissible under 15 U.S.C. § 78u(d)(5). The Ninth Circuit affirmed the district court's decision and the Supreme Court granted certiorari.

On June 22, 2020, an eight-justice majority rejected the petitioner's argument that *Kokesh* precluded the SEC from seeking disgorgement in federal court enforcement actions.[5] Instead, the Court held that disgorgement "that does not exceed a wrongdoer's net profits and is awarded for victims" could constitute permissible "equitable relief" under 15 U.S.C. § 78u(d)(5).[6]

While the decision preserves the SEC's ability to seek disgorgement in federal court, it also imposes some limits on that ability. Although the Court declined to lay out specific rules for disgorgement, it identified three ways in which past SEC disgorgement orders "test[ed] the bounds of equity practice,"[7] and left it to the lower courts to resolve how those three key principles, as discussed below, should be implemented.

Equitable Relief Should Be for the Benefit of Investors

First, the Court noted several times that § 78u(d)(5) restricts equitable relief to that which "may be appropriate or necessary for the benefit of ***investors***" (emphasis added). Citing case law and principles of statutory interpretation, the majority wrote that, to comply with this requirement, SEC disgorgement "must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains" and do "more than depriv[e] a wrongdoer of his net profits alone."[8] The opinion held that the equitable nature of disgorgement "generally requires the SEC to return a defendant's gains to wronged investors for their benefit."[9]

The *Liu* decision deferred addressing the question of whether disgorgement is an appropriate remedy when it is impractical or impossible to return funds to victims. This situation can arise in a variety of cases, including cases in which the victims are not necessarily investors (*e.g.*, in some Foreign Corrupt Practices Act cases in which a privately-held competitor business or a foreign government may be the victim), or if aggrieved investors are difficult to identify (as was the case with international investors in *Liu*). The Court also left for the lower courts to decide whether a disgorgement order directing funds be deposited with the US Treasury — which is how many SEC disgorgement orders have historically been effectuated — would be consistent with § 78u(d)(5)'s requirement that the remedy benefit investors.[10] Specifically, the Court stated that "[t]he lower courts may evaluate in the first instance whether that order [directing funds to the Treasury] would indeed be for the benefit of investors as required by § 78u(d)(5) and consistent with equitable principles." If orders of disgorgement can no longer be deposited with the US Treasury, then pursuing securities cases in federal court could become a less attractive remedy for the government in cases in which the "victims" are not easily ascertainable.

If disgorgement is only appropriate in cases where funds are returned to injured investors, it could have dramatic impact on the SEC's enforcement program. According to the Division of Enforcement's Annual Report for 2019, of the US$3.248 billion in disgorgement obtained that year, only US$247 million was returned to harmed investors.[11]

Disgorgement Should Not Involve Joint and Several Liability

Second, the Court noted that the SEC has sought to impose disgorgement liability through joint-and-several liability "in a manner sometimes seemingly at odds with the common-law rule requiring individual liability for wrongful profits."[12] In so doing, the Court questioned the viability of precedent requiring a tipper to disgorge a tippee's profits in insider trading cases.[13] In *Liu*, the Court explained that the SEC should not impose disgorgement through joint and several liability and instead should determine whether defendants can be "found liable for profits as partners in wrongdoing," or "whether individual liability is required."[14] As a result, only parties who participated in the wrongdoing will be liable to disgorge their own ill-gotten gains, which may discourage the SEC from naming defendants who are accused of no wrongdoing solely to obtain disgorgement. The exception is if the SEC can establish a sufficiently close connection between multiple defendants such that their profits can be disgorged collectively without the remedy becoming impermissibly punitive and thus not "equitable relief" authorized by the statute.[15]

Legitimate Expenses Must Be Deducted From Disgorgement

Finally, the Court stated that when determining disgorgement, the SEC "must" deduct legitimate expenses.[16] The Court explained that subtracting legitimate expenses from ill-gotten gains ensures the award falls "within the limits of equity practice while preventing defendants from profiting from their own wrong."[17] This is consistent with well-established precedent from *Rubber Company v. Goodyear*, which held that disgorgement is calculated using "the gain made upon any business or investment, when both the receipts and payments are taken into the account."[18]

Importantly, the decision in *Liu* suggests that an expense must be "wholly fraudulent" and have no independent value except for furthering the fraudulent scheme in order to be ineligible for the expense deduction.[19] In this case, the Court explained that some expenses from petitioners' scheme went toward lease payments and cancer treatment equipment, and found that such items arguably have value independent of fueling a fraudulent scheme. Using that framework, *Liu* may expand the scope of costs and expenses that can be deducted from ill-gotten gains, providing additional ammunition to defense counsel in negotiations and further limiting the impact of the disgorgement remedy.

Another area in which *Liu* could have practical impact is curtailing the SEC Staff's ability to argue that *all* revenue should be the subject of disgorgement under the principle established by the Supreme Court in *Root v. Railway Company*, which permitted the disgorgement of all revenue from a wrongdoer if the "entire profit of a business or undertaking" results from the wrongful activity.[20] Although the Court did not specify the appropriate measure of disgorgement in *Liu*, it did remand the case with instruction for the district court to assess the legitimacy of expenses, signaling a disapproval of a blanket assertion that all expenses were fraudulent and thus not deductible.[21]

Going forward, SEC Staff will likely advocate for a narrow interpretation of the Court's direction that legitimate expenses must be deducted from any award of disgorgement under 15 U.S.C. § 78u(d)(5), hence, whether the *Liu* decision will impact calculations at all remains an open question. Currently, the expenses and costs that can be deducted from the calculation of disgorgement are the subject of negotiation between the Staff and defense counsel, with the Staff often accepting that legitimate marginal costs can be deducted from gross revenues in the disgorgement analysis. As would be expected,

differences of opinion commonly arise in this context — particularly around arguments that some amount of fixed costs should be included in the deduction. But the *Liu* case may provide defendants with additional ammunition when arguing that certain overhead expenses or other fixed costs may be legitimate deductions if defendants can establish that the expenses have some independent business value. Of course, until the issue is more settled in the lower courts, both the SEC and defense counsel likely will continue to wrestle with the scope of "legitimate" expenses.

Looking Ahead: Impact on Administrative Proceedings and Other Agency Enforcement

Another significant aspect of the majority's decision is what it does not say — whether the limitations on SEC's disgorgement authority in federal court enforcement actions will also apply to SEC administrative proceedings. In *Liu*, the Court's analysis focused on the SEC's disgorgement authority under 15 U.S.C. § 78u(d)(5), which permits courts to award "equitable relief that may be appropriate or necessary for the benefit of investors." In contrast, Congress expressly authorized the Commission to obtain "disgorgement" in administrative proceedings under 15 U.S.C. § 77h–1(e), but that statute does not include the caveat that such relief must be "for the benefit of investors." Given the different scope and language of these two statutory disgorgement authorities, whether the limitations imposed by the Court would apply to disgorgement in the administrative context remains unclear.

Justice Thomas explained the practical impact of this potential divergence in his dissenting opinion: "[i]t is unclear whether the majority's new restrictions on disgorgement will apply to these proceedings as well. If they do not, the result will be that disgorgement has one meaning when the SEC goes to district court and another when it proceeds in-house."[22]

Finally, the decision could potentially impact other agencies that obtain disgorgement and other similar remedies in administrative proceedings, such as the Commodities Futures Trading Commission (CFTC), the Federal Trade Commission (FTC) and the Food and Drug Administration (FDA). Notably, neither the FTC nor the FDA is expressly authorized to obtain "disgorgement" as the SEC is in administrative proceedings under 15 U.S.C. § 77h–1(e) or the CFTC is under 7 U.S.C § 13a–1(d)(3). In fact, neither the FTC nor the FDA is expressly authorized to obtain "equitable relief," the statutory phrase at issue in *Liu*, but have instead obtained disgorgement and similar remedies from time to time based upon other statutory authority to enjoin violations of law.

Conclusion

The much-anticipated decision in *Liu* resolves the open question that has lingered since *Kokesh* and holds that the SEC has the authority to obtain disgorgement in federal court. But the decision leaves open important questions regarding the scope of the SEC's disgorgement authority, and it remains to be seen how lower courts (and the Commission Staff) will interpret the three principles that the Court indicated should guide lower courts in orders of disgorgement, and whether such principles will also be applied in SEC administrative proceedings.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

William R. Baker III
william.baker@lw.com
+1.202.637.1007
Washington, D.C.

Erin Brown Jones
erin.brown.jones@lw.com
+1.202.637.3325
Washington, D.C.

Leslie R. Caldwell
leslie.caldwell@lw.com
+1.415.395.8134
+1.650.328.4600
San Francisco | Silicon Valley

Kevin Andrew Chambers
kevin.chambers@lw.com
+1.202.637.2248
Washington, D.C.

Andrew Clubok
andrew.clubok@lw.com
+1.202.637.3323
+1.212.906.1272
Washington, D.C. | New York

Blair Connelly
blair.connelly@lw.com
+1.212.906.1200
New York

Alice S. Fisher
alice.fisher@lw.com
+1.202.637.2232
Washington, D.C.

Douglas N. Greenburg
douglas.greenburg@lw.com
+1.202.637.1093
Washington, D.C.

Joshua G. Hamilton
joshua.hamilton@lw.com
+1.424.653.5509
+1.213.891.8742
Century City | Los Angeles

Brian E. Kowalski
brian.kowalski@lw.com
+1.202.637.1064
Washington, D.C.

Roman Martinez
roman.martinez@lw.com
+1.202.637.3377
Washington, D.C.

Matthew Rawlinson
matt.rawlinson@lw.com
+1.650.463.3076
Silicon Valley

Sandeep Savla
sandeep.savla@lw.com
+1.212.906.1395
+44.20.7710.1000
New York | London

John J. Sikora Jr.
john.sikora@lw.com
+1.312.876.6580
Chicago

Faiza Hasan
faiza.hasan@lw.com
+1.202.637.2309
Washington, D.C.

Christopher M. Ting
christopher.ting@lw.com
+1.202.637.3327
Washington, D.C.

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Endnotes

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1 *Kokesh v. SEC*, 137 S. Ct 1635 (2017).

2 *Id.* at 1643 n.3.

3 *See e.g., United States v. Latorella*, 2017 U.S. Dist. LEXIS 98849, at *9 n.4 (D. Mass. June 27, 2017) ("It bears noting that the Supreme Court expressly reserved the question whether courts possess authority to order disgorgement in SEC enforcement proceedings.").

4 *SEC v. Liu,* 262 F. Supp. 3d 957, 975–976 (CD Cal. 2017).

5 Only Justice Clarence Thomas dissented. *See infra* at 5.

6 Op. at 1.

7 *Id.* at 12.

8 *Id.* at 16.

9 *Id.* at 15.

10 *Id.* at 16–17 (calling it an "open question whether, and to what extent, that practice nevertheless satisfies the SEC's obligation to award relief 'for the benefit of investors'").

11 U.S. Securities and Exchange Commission Division of Enforcement, 2019 Annual Report, available at https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

12 *Id.* at 17.

13 *Id.*

14 *Id.* at 18.

15 *Id.*

16 *Id.* at 19.

17 *Id.*

18 *Rubber Co. v. Goodyear*, 76 U.S. 788, 804 (1869).

19 Op. at 19.

20 *Root v. Railway Co.*, 105 U.S. 189, 203 (1881).

21 Op. at 19.

22 *Id.* at 8 (Thomas, J., dissenting).