

# 6 Ways SEC May Respond To High Court Disgorgement Ruling

By Gerald Russello, Kenyon Hall and Sarah Gromet (August 19, 2020)

On June 22, the U.S. Supreme Court affirmed, but substantially narrowed, the ability of the U.S. Securities and Exchange Commission to seek disgorgement in federal court in *Liu v. SEC*. In an 8-1 decision, the court discussed two key limitations on the SEC's ability to obtain disgorgement in federal court.

First, except under narrow circumstances, disgorgement awards should be limited to wrongful profits for which a person or entity is individually liable, rather than imposing joint liability. And second, disgorgement awards should "not exceed a wrongdoer's net profits."

Put differently, the Supreme Court found that courts must deduct legitimate business expenses when calculating disgorgement amounts. The court also cast doubt on whether the SEC can seek any disgorgement in federal court in instances where the disgorged funds will be deposited with the U.S. Department of the Treasury instead of being returned to harmed investors.

We expect the *Liu* decision to have significant implications for the SEC's enforcement program given the outsize role disgorgement has traditionally played in the SEC's enforcement practice.

For context, between 2015 and 2019, the SEC collected an average of \$2.6 billion in disgorgement per year. In stark contrast, the SEC collected an annual average of \$1.164 billion in civil money penalties — less than half of the disgorgement amount — during the same period.

Indeed, Steven Peikin, co-director of the SEC's Division of Enforcement, recently described disgorgement as "a central component of meaningful relief and often the surest way to restore at least a portion of investors' losses." The limitations on disgorgement reflected in the *Liu* decision will likely impact both the SEC's ability to rely on disgorgement as a primary source of monetary recovery and the leverage it has to persuade individuals with limited disgorgement exposure to settle on terms favorable to the SEC.

As a threshold matter, it bears noting that the *Liu* decision applies only to the SEC's ability to obtain disgorgement in federal court — its ability to obtain disgorgement in administrative proceedings remains unchanged. One significant consequence of the decision may be an increase in the amount of enforcement actions brought as administrative proceedings, although there are strong legal and policy arguments to be made that key aspects of the decision apply regardless of forum.

With respect to those actions that are brought in federal court, we anticipate that the SEC may seek to implement some or all of the following strategies to limit the impact of *Liu*.

## 1. The SEC may seek to limit the definition of "legitimate business expenses."

While the *Liu* decision states plainly that disgorgement calculations should exclude



Gerald Russello



Kenyon Hall



Sarah Gromet

"legitimate business expenses," the court provided limited guidance about what this may encompass. Accordingly, we expect that the SEC may continue to take a narrow view as to what constitutes a legitimate business expense for purposes of calculating disgorgement.

Firms should anticipate this approach and carefully craft advocacy around what expenses should be netted out in disgorgement calculations. Similarly, firms should identify and be prepared to provide support for their legitimate business expenses to inform any discussion of disgorgement amounts with the SEC.

Most notably, this should have an immediate and profound impact on the SEC's The Foreign Corrupt Practices Act enforcement program, where disgorgement historically has been calculated on a gross profits, rather than net profits, basis. The SEC's argument before the Supreme Court and recent edition of its joint FCPA guide with the U.S. Department of Justice reflect that net profits should be the new method following Liu.

## **2. The SEC may seek increased civil money penalties.**

The SEC may attempt to mitigate the impact of diminished disgorgement amounts by levying higher civil money penalties against defendants. There is some support for this approach. Specifically, the statutory provisions permit penalties up to the gross pecuniary amount gained from the misconduct, which likely exceeds the amount the SEC would be able to recover through disgorgement in light of Liu.

Importantly, however, this could create significant policy concerns for the SEC, and courts may be reluctant to permit the SEC to obtain through a penalty what it cannot obtain through disgorgement. Perhaps equally relevant is the fact that courts rarely, if ever, award such maximum penalties except in the most egregious fraud cases.

Thus, there is little support for such penalties in the vast majority of SEC cases. The SEC may also claim that it can seek a separate penalty per violation in accordance with the various penalty statutes; however, courts have traditionally disfavored awarding penalties in this fashion.

## **3. The SEC may seek to name relief defendants.**

Prior to Liu, the SEC routinely sought disgorgement from a wrongdoer and those affiliates to whom some benefit of the wrongdoing may have accrued, holding them jointly liable, regardless of whether the relief defendant was involved in the misconduct. Although the Liu court did not address this practice directly, its determination that disgorgement should generally be limited to a person or entity's individual net profits limits the SEC's ability to seek disgorgement from defendants who were not also "engaged in concerted wrongdoing."

Adding relief defendants may render litigation costly and unwieldy while offering limited returns. Moreover, in addition to simple legal challenges to the use of relief defendant liability, relief defendant status may also be challenged where a party can establish a legitimate claim to the disputed assets.

Courts have upheld challenges to the addition of relief defendants where assets were received as payment for services rendered, where assets were paid to a creditor, and where assets were the profits of a nonculpable party's investment. Historically, the SEC used relief defendant actions for limited purposes, and expansion of this practice may force the SEC to litigate the legitimacy of any prospective relief defendants before obtaining disgorgement from such parties.

#### **4. The SEC may investigate more individuals for potential wrongdoing.**

Given the limitations on collective liability, and the potential issues raised by attempts to add relief defendants, the SEC may prefer to pursue disgorgement from more individual wrongdoers. Here, too, the SEC may face challenges raised by Liu.

The Liu court limited disgorgement to net profits. As a result, individual defendants may argue that certain categories of compensation, including salaries and commissions, do not constitute profits and are thus exempt from disgorgement. This challenge, though limited, may serve to narrow disgorgement amounts for individual defendants.

#### **5. The SEC may argue that a venture was entirely fraudulent, precluding any legitimate business expenses.**

The SEC may attempt to prevent the deduction of any legitimate business expenses by arguing that the entire venture was fraudulent and that any related business expenses were inherently illegitimate.

A concept borrowed from economics, the "fraud-created-the-market" theory, may provide support for the SEC here. This theory posits that, because federal securities laws impose standards of marketability on all securities entering the market, certain unmarketable securities would not be permitted entry to the market but for fraud. The SEC may similarly argue that any and all business expenses were incurred in furtherance of the fraud, and would not exist but for the fraud.

This argument may be of limited utility, for example, when discussing alleged misconduct at a large, public company or well-established financial institution. However, the SEC may seek to employ the theory more often in instances involving deliberate, widespread abuse, as in cases alleging an offering fraud or widespread stock manipulation by a firm (e.g., one specializing in penny stocks), or cases where there is widespread abuse of customer assets by a broker or group (e.g., churning accounts).

This theory, too, can be challenged on the basis of Liu, as the court noted that an expense may be legitimate, even "when the 'entire profit of a business or undertaking' results from the wrongdoing." Thus, courts may be ill-disposed toward applying variations on this theory to disgorgement.

#### **6. The SEC may take a more expansive view of who is harmed by a purported violation of securities laws.**

In the Liu decision, the Supreme Court highlighted language in the statutory provision authorizing the SEC to seek equitable relief stating that the commission may seek any equitable relief "that may be appropriate or necessary for the benefit of investors."

The court called into question the SEC's practice of seeking disgorgement of funds to be deposited with the Treasury, noting that the SEC's use of an equitable remedy must do more than simply benefit the public at large to avoid rendering the language of the statute meaningless.

While the Liu court ultimately did not decide whether disgorgement of funds to be deposited with the Treasury, rather than returned to harmed investors, is ever permissible, the decision leaves this practice open to challenge in the future. This, too, may have a

substantial impact on areas such as FCPA, insider trading and accounting misconduct where disgorgement is often submitted to the Treasury rather than returned to investors.

In an effort to avoid the issue, we expect that the SEC may thus take a more expansive view of who is harmed by an alleged violation of securities laws in order to identify individuals or entities to whom disgorged funds can be distributed.

## **Conclusion**

In sum, *Liu v. SEC* preserved disgorgement in federal court proceedings, albeit in diminished form. In its aftermath, the SEC may seek to implement a number of strategies to limit *Liu*'s impact, although defendants and their advocates are well-positioned to resist many of these attempts to narrow or circumvent *Liu*.

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*Gerald Russello is a partner, Kenyon Hall is an associate and Sarah Gromet is a staff attorney at Sidley Austin LLP.*

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