Alerts & Publications

Supreme Court Reins in SEC's Disgorgement Authority

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In *Liu v. SEC*, the Supreme Court upheld the SEC's ability to obtain disgorgement of ill-gotten gains in federal district court enforcement actions by an 8-1 vote. But what the Court gave the SEC with one hand, it significantly snatched back with the other. By the same lopsided vote, the Court sharply rejected expansive disgorgement claims that the SEC has pressed over the last several decades. Disgorgement, the Court held, is limited to net profits; must be "for the benefit of investors"; and generally cannot be imposed jointly and severally, absent concerted wrongdoing by the defendants. The impact of those limits remains to be seen. Because the Court left it to the lower courts to determine the precise contours of disgorgement in any particular case, and because *Liu* does not directly address disgorgement in SEC administrative enforcement actions, *Liu* will not be the last word. But the Court cemented disgorgement as a potent remedy that will undoubtedly figure prominently in SEC enforcement actions and will demand that counsel pay careful attention to and persuasively apply the limits identified by the Court in SEC matters.

The Parties' Arguments

Since 2002, the SEC has had the express statutory power to ask federal courts to order "any equitable relief that may be appropriate or necessary for the benefit of investors." Even before Congress confirmed that power by explicit statutory language, the SEC had persuaded courts that disgorgement of profits was among the arsenal of equitable remedies it could seek against securities law violators. And the SEC successfully persuaded a string of lower courts to force securities law violators to surrender all funds related to the violation, expanding the reach and the power of that remedy as a key tool to deter wrongdoers. Defendants increasingly pushed back on the SEC's aggressive pursuit of all proceeds, not just net profits, as an equitable remedy and eventually, two defendants charged for an offering fraud persuaded the Supreme Court to take up the question whether the generalized and amorphous reference to "any equitable relief" includes disgorgement.

The SEC and the petitioners took polar opposite views. The petitioners' central argument was that, unlike the numerous other remedies available to the SEC, disgorgement is not specifically mentioned and its absence from the text of the statute is strong evidence that Congress purposely omitted it. They also argued that the SEC's disgorgement practices, including its practice of having disgorged funds paid to the Treasury (rather than returning the funds to defrauded investors), showed that disgorgement is a penalty, not an equitable remedy. The SEC argued that the SEC may seek "any equitable relief" and that disgorgement is an established equitable remedy, which the SEC has the power to seek in judicial actions. In support of its position, the SEC cited a long history of lower courts that approved disgorgement, including disgorgement that the petitioners characterized as penal rather than equitable. Several Justices at oral argument indicated a preference for a compromise position between those two extremes.

The Court's Decision: Three Key Limits and Three Battleground Areas

The Court's opinion, written by Justice Sotomayor (with Justice Thomas as the sole dissenter, who would have entirely eliminated disgorgement authority) ultimately found widespread support for a middle ground that raises as many questions as it answered. In a win for the SEC, the Court held that disgorgement is an equitable remedy available to the SEC. But before the SEC was able to celebrate, the Court overturned the SEC's expansive version of disgorgement by relying on the same equitable history the SEC had championed. The Court held that:

- Disgorgement ordered must be "for the benefit of investors."
- Disgorgement amounts are limited to "net profits."
- Although disgorgement may be ordered jointly against those engaged in concerted wrongdoing, it may not be imposed on a general joint and several liability theory.

These limitations will be the subject of battles that will be waged in the district court. For example, the SEC will have the burden of proving that any disgorgement sought by the SEC will be "for the benefit of investors." *Liu* should force the SEC to abandon its longstanding practice of refusing to reduce disgorgement by the amount of legitimate expenses incurred. Defendants should be prepared to submit evidence of their expenses and to litigate over whether such expenses are "legitimate." And defendants should be prepared to counter SEC attempts to hold them responsible for profits that others received.

Because the SEC resolves many cases by consent decree, it may take some time before the parameters of *Liu* are worked out. In the meantime, counsel will be called upon to fashion creative arguments and to emphasize the Court's limiting principles to fight for the best outcomes for clients.

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