Outside Counsel

Supreme Court Clarifies Disgorgement In Securities Cases and Beyond

By **Anthony M. Sabino**

Disgorgement, in recent years a favored tool of the U.S. Securities and Exchange Commission in its battles against securities fraud, is defined by one lay dictionary as the return of illegal profits under compulsion of court order. *See* www.merriam-webster.com. Yet the term evaded a more exacting definition three years ago when the U.S. Supreme Court confined itself to decreeing that the remedy is subject to a five-year statute of limitations, but reserved all other inquires for another day. *See Kokesh v. S.E.C.*, 581 U.S. ___ (2017).

Those questions have now been answered in *Liu v. S.E.C.*, 591 U.S. ___ (No. 18-1501) (June 22, 2020), where an overwhelming majority of the court confirmed there is statutory authority for the Commission to seek, and for federal courts to bestow, disgorgement as an equitable remedy, within boundaries circumscribed by axioms of equity jurisprudence which have been extant since the founding of the Republic.

Important as this new decision may be to the realm of securities enforcement, it also holds inestimable value to understanding equitable remedies generally. For that reason, this newly minted landmark is certain to extend its influence into other legal realms.

Liu's facts reveal an all too familiar scenario. The petitioners raised $27 million from overseas investors in a private stock offering made under the auspices of the "EB-5 Program," which permits noncitizens to apply for permanent residence in the United States, provided they invest in certain commercial enterprises. An investigation revealed that some three quarters of investors' funds were spent on marketing and salaries, contrary to representations made in the offering documents. Even worse, Mr. Liu allegedly diverted sizable funds to personal accounts, and to a company controlled by his spouse.

At the behest of the SEC, the district court ordered the petitioners to disgorge nearly the entire $27 million, without deducting business expenses, and furthermore held the Lius jointly and severally liable. The U.S. Court of Appeals for the Ninth Circuit affirmed.

Writing for the 8-1 majority (Justice Clarence Thomas filed a lone dissent), Justice Sonia Sotomayor acknowledged that the "protean character" of disgorgement rendered the court's task more difficult. Nonetheless, by drawing upon canons of equity jurisprudence, the majority espoused two principles. First, and with substantial reliance upon a host of renowned treatises, the court proclaimed that equity "has long authorized courts to strip wrongdoers of their ill-gotten gains."

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Second, it is axiomatic that the sums to be restored to victims is benchmarked by the malefactor's "net unlawful profits." To do otherwise would "transform[ ] an equitable remedy into a punitive sanction," an outcome incompatible with the norms of equitable relief. *See Marshall v. Vicksburg*, 15 Wall. 146 (1873) (equity never "lends its aid to enforce a forfeiture or penalty"). Among other things, the court analogized disgorgement to the well established restorative of an accounting for profits, historically a form of equitable restitution. *See Kansas v. Nebraska*, 574 U.S. 445 (2015) (ordering Nebraska to disgorge its gains from violating an interstate water compact).

The court made two final declarations that would guide the remainder of the ruling made this day. First, Congress had incorporated these "longstanding equitable principles" into the relevant section of the federal securities code; and, second, the legislators had "prohibited the SEC from seeking an equitable remedy in excess of a defendant's net profits."

In the nascent years of disgorgement litigation, the Commission had generally pursued its claims within these limits. However, noted Sotomayor, as time passed the agency pushed the envelope, persuading lower courts to direct malefactors to pay disgorged monies to the U.S. Treasury, but not victims, apportion liability jointly and severally, and assess disgorgement awards without deducting even legitimate business expenses.

Mindful of this accretion to the SEC's power, the majority now turned to the controlling statute, Section 78u(d)(5), a modern addition to the 1934 Securities and Exchange Act. Subtitled "Equitable Relief," the proviso authorizes the Commission to seek, and any federal court to grant, "any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C. §78u(d)(5).

Justice Sotomayor now summarized the petitioners' contentions as essentially twofold: one, disgorgement was not a true equitable remedy, but rather an impermissible penalty; and two, the agency was guilty of the same overreaching already identified.

The SEC parried by steadfastly contending that disgorgement is an equitable remedy which falls squarely within the compass of Section 78u(d)(5), and that the statute's paramount goal is

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to deprive wrongdoers of their ill-gotten gains. Thus, ordering disgorgement to be paid to the U.S. Treasury, without disbursements to investors, does no violence to the proviso.

Taking full measure of the above, the *Liu* court first ruled that Section 78u(d)(5) by no means entitles the SEC to unrestrained relief. Quite to the contrary, Sotomayor informs, the statutory text insists upon "a remedy tethered to a wrongdoer's net unlawful profits."

Invoking the fundamental rule of statutory construction that every clause and word of a provision must be give effect, if possible, the majority held that the SEC's interpretation of the statute did violence to that precept. Sotomayor remonstrated that merely extracting illicit gains from a stock swindler, and then depositing them into the general treasury without payment to defrauded investors, falls short of Section 78u(d)(5)'s explicit command that equitable relief thereby obtained must be "for the benefit of investors."

Next, the court soundly rejected the SEC's allegation that Congress' widespread and undefined use of "disgorgement" here and elsewhere granted the agency the right to fashion equitable remedies at its sole discretion. Even if disgorgement was legislative shorthand for unfettered relief, Sotomayor opined, Congress could still "not expand the contours of that term beyond a defendant's net profits—a limit established by longstanding principles of equity."

Equally problematic in the case at hand was the imposition of joint and several liability upon the petitioners. The majority decried enforcing disgorgement by a method "seemingly at odds with the common-law rule requiring individual liability for wrongful profits." Sotomayor was constrained to point out that disgorgement compelled under the threat of joint and several liability risks transmuting an equitable remedy into a penalty.

Certainly, Sotomayor added, fraudsters working in concert presents a different situation. There, the common law has long advocated joint and several liability for coordinated wrongdoing. But with respect to the case at bar, the record below lacked any indicia as to whether the married petitioners acted as co-conspirators or if one might have been the proverbial innocent spouse. Given such, the majority

relegated the issue to the lower courts for further adjudication.

The court's third and final holding set forth the methodology for determining (or, in the instant case, redetermining on remand) what monies a miscreant can be compelled to disgorge. Given that the majority had already enunciated the bedrock maxims of equity which controlled that calculus, it was a simple matter for Sotomayor to instruct the lower courts to allow the deduction of legitimate business expenses (if any) , even in the most corrupt of fraudulent schemes. That subtraction would yield a more accurate picture of the lawbreakers' true profits, thereby resulting in a more equitable order of disgorgement.

Notwithstanding all these valuable postulations, as aforestated a fully developed record was still lacking; thus, *Liu* was remanded for further proceedings. Yet this new landmark's salient points remained: the SEC is statutorily authorized to seek equitable remedies appropriate and necessary for investor protection, and disgorgement falls with the ambit of such relief; disgorgement stands as a remedy cabined by maxims of equity jurisprudence, foremost among those axioms the principle that the sum to be disgorged is measured by the defrauder's ill-gotten gain; and, finally, recoveries should be restored to the victims of the miscreant's foul deeds, and not given over to the general treasury.

Taking full measure of the above, the 'Liu' court first ruled that Section 78u(d)(5) by no means entitles the SEC to unrestrained relief. Quite to the contrary, Justice Sotomayor informs, the statutory text insists upon "a remedy tethered to a wrongdoer's net unlawful profits."

Before concluding, attention must be paid to the erudite, albeit solitary, dissent. True to his originalist views, Justice Thomas emphasized that disgorgement was unheard of until the Twentieth Century, and was therefore wholly unknown at the time of the Founding (a finding which stands in marked contrast to the majority's casual admission in a parenthetical that the remedy is of "recent vintage").

The learned dissent warns that today's holding invites the "great mischief" that comes from injecting judicially created relief into statutes. *See Correctional Services Corp. v. Malesko*, 534 U.S. 61, 75 (2001) (Scalia, J., concurring). Equally compelling is Justice Thomas' reminder that in the instant case the district court's order to disgorge nearly $27 million, when aggregated with another $8 million in SEC penalties, virtually guarantees that the victims of the petitioners' deceit will recover nothing in their own litigations. No doubt this profound opposition shall resonate well beyond the matter at hand.

In closing, the denouement of *Liu* is not its remand, but rather its confirmation that disgorgement is a component of the equitable relief available to the SEC in enforcement cases, strictly constrained in its application, and undeniably subordinate to venerable axioms of equity jurisprudence. Lastly, and as Justice Thomas' singular dissent reminds, such a remedy should only be imposed with great restraint and circumspection. The last shall no doubt prove highly influential the next time the high court deliberates upon equitable remedies in securities fraud cases and beyond.