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Liu V. SEC Offers Opportunity For Clarity In Disgorgement Law

By **Russell Ryan** (April 16, 2020, 6:19 PM EDT)

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Judging from last month's U.S. Supreme Court oral argument in Liu v. U.S. Securities and Exchange Commission,[1] a case challenging the SEC's decades-old practice of demanding disgorgement of illicit gains from securities law violators, it appears likely (1) that the SEC's disgorgement victory in that case will be set aside — with a likely remand for further proceedings — but (2) that the court will stop short of ruling categorically that the SEC can never obtain disgorgement in federal court cases.

That may be the right outcome, but how the court gets there could determine whether the law surrounding SEC disgorgement is substantially clarified or further muddled.

The specific disgorgement order in Liu suffers from several defects, but the litigants and justices appear to be focused mostly on only two of them. Several justices suggested through their questioning that the disgorgement order in the case was not an equitable remedy — and thus not statutorily authorized — because it exceeded the amounts personally gained by the defendants and because the SEC had no plan to return the disgorged gains to investors harmed by the defendant's violations.

So far, so good – that's more than enough reason to vacate the disgorgement order.

But let's hope the court avoids suggesting, even inadvertently, that these were the only two flaws in the Liu disgorgement order, or worse yet that the order would have been fine if only it had been limited to the amount of the defendants' personal gains and if only the SEC had promised to establish a fair fund to distribute those gains to harmed investors.

To reduce the need for future litigation over disgorgement, the court should purposefully signal — even if only through subtle dictum — that disgorgement orders are equitable only if they meet at least three additional conditions.

First, the court should caution lower courts in disgorgement cases to focus not only on the amount of the defendant's net personal gain and where the disgorged funds will end up going, but also on where those funds will come from.

As I suggested several years ago,[2] under established precedent in other contexts — most notably an

Employee Retirement Income Security Act case called Great-West Life & Annuity Insurance Co. v. Knudson[3] — in order for a restitutionary remedy to qualify as equitable, the specific pool of funds being returned to the victim must remain extant and represent the actual tainted gains received by the wrongdoer.

Under the rationale of Great-West, if those specific funds no longer exist, or if they have since been transferred, squandered or commingled with other funds, any disgorgement award in the SEC's favor is simply an order to pay a substitutionary sum of money, which is a classic remedy at law, not a remedy in equity.[4]

By reiterating this point explicitly in Liu, the court might put an end to the SEC's historical tendency to demand disgorgement even against defendants who no longer possess the funds in question and to hold many unrelated defendants jointly and severally liable for disgorgement of gains that went to others involved in the wrongdoing.

Given the SEC's relatively low success rate in collecting on these kinds of disgorgement orders (much less getting money back to investors), putting an end to them should have little practical effect on the total amounts the SEC actually collects and distributes to harmed investors.

Second, although there was not much (if any) disagreement in the Liu case over the specific dollar amounts upon which the SEC's disgorgement calculation was based, the court should purposefully avoid any subtle endorsement of the notion — long held by the SEC and widely accepted by lower courts — that the SEC's burden was merely to present a reasonable approximation of the disgorgement amount, with the burden of proof then shifting to the defendant to disprove the SEC's approximation.

Because it is not an issue in Liu, the court should leave the door open to future challenges to this questionable burden-shifting practice.

Third, the court should purposefully avoid prejudging another issue not presented in Liu: Whether disgorgement, even if permissible equitable relief in some circumstances, requires a predicate finding of scienter or some other indicator of truly culpable wrongdoing, as opposed to mere negligence or even strict liability.

In Liu, the district court granted summary judgment only on the SEC's claim of so-called nonscienter fraud under Securities Act Section 17(a)(2), but it then cited "overwhelming evidence" of the defendants' "high degree of scienter" as a factor weighing in favor of an injunction,[5] thus making the case an imperfect vehicle for deciding the question even if it had been presented.

But because the defendants in Liu did not raise the issue, and because the district court made an explicit finding of scienter in the case, the Supreme Court should purposefully avoid suggesting, even by subtle negative inference, that proof of scienter or other culpable wrongdoing is irrelevant in determining whether disgorgement is a permissible equitable remedy.

In particular, the court should avoid any dictum that could later be seized upon to legitimize disgorgement in cases based solely on negligence or strict liability.

As explained in one of the first scholarly articles to address SEC disgorgement, and assumed in its title, the agency's earliest disgorgement victories in the 1960s and 1970s were premised on illicit gains by proven wrongdoers — most typically insider trading cases and other cases featuring scienter-based fraud under Securities Exchange Act Section 10(b) and SEC Rule 10b-5.[6]

Although the agency now routinely demands disgorgement even in non-fraud cases, that subtle and gradual extension of the disgorgement remedy is of dubious validity and, at a minimum, it has not yet been rigorously vetted by lower courts. The Supreme Court's opinion in Liu therefore should not foreclose future legal challenges in this area.

One final point, at the risk of committing heresy. During oral argument, as in most casual discussions about SEC disgorgement, there appeared a universal presumption that empowering and even incentivizing the SEC to seek restitution for harmed investors wherever possible is the optimal public policy choice.

I don't necessarily disagree with that premise, but it's far from truistic, and the court should avoid presuming it as such. To my knowledge neither Congress nor the SEC has ever conducted rigorous factfinding or policy analysis to demonstrate that investors and markets are best served when the SEC diverts its limited staff and resources from other important priorities to pursuing monetary recoveries as a surrogate for private parties.

For example, no such analysis was offered in 2002 when Congress enacted the "fair fund" provisions of the Sarbanes-Oxley Act, which vastly expanded the SEC's power and incentives to seek monetary sanctions that could then be distributed to harmed investors.[7]

Even in its own 2003 report on disgorgement, which was mandated by Sarbanes-Oxley Section 308(c), the SEC simply assumed the desirability of having the SEC recover losses for investors, even as it candidly acknowledged the substantial public costs, staff diversions, and logistical difficulties involved in doing so.[8]

In most walks of life, when private citizens or businesses suffer injury or financial loss at the hands of others, they seek redress through private negotiation and the private legal system, with no expectation that a federal government agency will spare them that burden by avenging their loss for them.

Believe it or not, Congress had ample reasons for not assigning that burden to the SEC when it created the agency in 1934, and over the ensuing decades at least a handful of brave SEC commissioners, academic scholars, and other commentators have openly questioned whether the agency should be, in essence, a governmental collection agent for private parties.[9]

This is an especially pertinent question in the case of investment losses, because there's no shortage of private legal claims that can be asserted against wrongdoers — nor private attorneys incentivized to pursue them. But because that question was not presented in the Liu case, the Supreme Court should not unwittingly assume the answer away when it decides the case.

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[1] Supreme Court Docket No. 18-1501, Transcript of Oral Argument (March 3, 2020), copy available at www.supremecourt.gov/oral_arguments/argument_transcripts/2019/18-1501_8n59.pdf.

[2] Russell G. Ryan, “The Equity Façade of SEC Disgorgement,” 4 Harv. Bus. L. Rev. Online 1, 6-11 (Nov. 2013), available at https://www.hblr.org//wp-content/uploads/sites/18/2013/11/Ryan__The-Equity-Fa%C3%A7ade-of-SEC-Disgorgement.pdf.

[3] 534 U.S. 204 (2002).

[4] To be sure, such an order might seem fair and “equitable” in common everyday parlance, but that does not make it a remedy in equity of the kind typically awarded by courts of chancery in the days of the divided bench. These two vastly different understandings of “equitable” should not be casually conflated.

[5] 262 F. Supp. 3d 957, 972 (C.D. Cal. 2017).

[6] John D. Ellsworth, “Disgorgement in Securities Fraud Actions Brought by the SEC,” 1977 Duke L. J. 641 (1977).

[7] 15 U.S.C. § 7246.

[8] SEC Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002 (2003), available at www.sec.gov/news/studies/sox308creport.pdf.

[9] See generally Barbara Black, “Should the SEC Be a Collection Agency for Defrauded Investors?” 63 Bus. Law. 317 (Feb. 2008).