

### WHITE-COLLAR CRIME

# 'Liu v. SEC': One Year Later

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In *Liu v. SEC*, the U.S. Supreme Court affirmed the SEC's ability to seek disgorgement as an equitable remedy for violations of the securities laws, but clarified that this power is limited by certain long-standing principles. 140 S. Ct. 1936 (2020). After Congress passed the National Defense Authorization Act for Fiscal Year 2021 (NDAA) amending the Securities Exchange Act of 1934 (Exchange Act) to provide the SEC with explicit authority to seek disgorgement in federal court, H.R.6395, 116th Cong. (2020) §6501, some wondered what the effect would be on the limiting principles set out in *Liu*. A year later, courts are thus far consistently applying the *Liu* limiting principles

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notwithstanding the NDAA's amendments. Therefore, practitioners should continue to look to *Liu* for the relevant limits on disgorgement as an equitable remedy.

### Evolution of SEC's Power To Seek Disgorgement: 'Kokesh' and 'Liu'

Prior to the passage of the NDAA, the SEC had argued that disgorgement was an "equitable remedy" and therefore appropriately cabined within §21(d)(5) of the Exchange Act's allowance for "any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C. §78u(d)(5). The Supreme Court has historically referred to disgorgement as an equitable remedy, and until recently, there had not been a serious challenge to the SEC's ability to seek disgorgement.

That all changed four years ago when the Supreme Court held in *Kokesh v. SEC* that disgorgement orders constitute a "penalty" for purposes of statute of limitations



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and included a footnote questioning (without answering) whether the term "equitable relief" as used in §21(d)(5) permitted the SEC to obtain the remedy of disgorgement under any circumstances. 137 S. Ct. 1635, 1639, 1642 n.3, 1643-45 (2017).

Three years later, the court in *Liu v. SEC* addressed this question head on, concluding that while the SEC could seek the remedy of disgorgement, the remedy is limited by three principles:

- Any disgorgement award sought by the SEC must be "awarded for victims" and be "appropriate or necessary for the benefit of investors," which means something more than a benefit to the public at large;
- A disgorgement award must be limited to the "net profits"

gained by the wrongdoer from his or her violation of securities laws, taking into account deductions for “legitimate expenses” that have “value independent of fueling a fraudulent scheme”; and

- Joint-and-several disgorgement liability may not be imposed absent a showing of “concerted wrongdoing” by multiple individuals. *Liu*, 140 S. Ct. at 1946-50.

### 2021 NDAA Did Not Affect the Limiting Principles of ‘Liu’

The section of the NDAA discussing the SEC’s disgorgement authority incorporates the limiting principles expressed in *Liu*. For instance, the NDAA permits the SEC to seek disgorgement “of any unjust enrichment,” thereby incorporating *Liu*’s approach to disgorgement as a remedy seeking a wrongdoer’s *net profits*. §6501(a)(1)(B)(ii). The NDAA further specifies that the remedy of disgorgement is available only against the “person who received such unjust enrichment,” thereby incorporating the court’s rejection in *Liu* of joint-and-several liability. *Id.*

Courts continue to apply *Liu*’s requirement that any disgorgement be “awarded for victims” and be “appropriate or necessary for the benefit of investors,” despite the fact that similar type language did not make its way into the NDAA. These recent decisions demonstrate that the NDAA has not increased the SEC’s leeway in

depositing funds with the Treasury. See, e.g., *Penn*, 2021 WL 1226978, at \*13-14.

If anything, the NDAA should be thought of more as a response to the court’s holding in *Kokesh* that disgorgement orders are limited to a five-year statute of limitations. Specifically, the NDAA increased the statute of limitations for disgorgement for any violations that require the SEC to establish scienter from 5 years to 10 years from the latest date of misconduct. §6501(a)(3).

Accordingly, the NDAA does not represent a legislative hammer coming down on the limiting principles outlined in *Liu v. SEC*. Practitioners should keep in mind that (1) the NDAA’s amendments do not meaningfully change the legal standards applicable to SEC disgorgement actions, and (2) there is a growing body of case law that applies *Liu*’s limiting principles notwithstanding the NDAA. See, e.g., *SEC v. Collectors Coffee*, 2021 WL 1956369, at \*9 (S.D.N.Y. May 17, 2021); *SEC v. Penn*, 2021 WL 1226978, at \*13-14 (S.D.N.Y. March 31, 2021); *SEC v. Yang*, 2021 WL 1234886, at \*3-9 (C.D. Cal. Feb. 16, 2021).

### Open Questions and Advice in the Wake of ‘Liu’

Given that the limiting principles of *Liu* are alive and well, the open questions (and equal number of interpretations)



resulting from these principles are more important than ever to understand. Below are just a few of those questions.

**What Are ‘Legitimate Expenses?’** One of the questions arising from *Liu* is what expenses are considered to be “legitimate” as the Supreme Court used that term in *Liu*, such that they should be deducted from any disgorgement award.

Prior to *Liu*, the following expenses, among others, have previously been deemed “legitimate” by courts: (1) direct transaction costs such as brokerage commissions, advisory fees, trading costs, fees paid to transfer agents, or transfer taxes already paid, see, e.g., *Securities and Exchange Commission v. Bronson*, 246 F. Supp. 3d 956, 973-976 (S.D.N.Y. 2017); (2) management compensation, labor, and office expenses, see *Kars 4 Kids v. America Can!*, 2020 WL 1550804, at \*8 (D.N.J. April 1, 2020); and (3) business expenses such as phone charges, underwriting costs, and other

overhead expenses that a company would have incurred regardless of whether the scheme was fraudulent, see *S.E.C. v. Thomas James Associates*, 738 F. Supp. 88, 92 (W.D.N.Y. 1990).

Although *Liu* did not specifically address what would be considered a “legitimate expense,” the court generally stated that the “cost and expense of conducting [a] business” and “marginal costs incurred in producing the revenues that are subject to disgorgement” should be deducted from a disgorgement award. 140 S. Ct. at 1949-50. Post-*Liu*, courts continue to deduct legitimate expenses from disgorgement awards that have “value independent of fueling a fraudulent scheme,” including brokerage commissions and wire transfer fees. See, e.g., *SEC v. Mizrahi*, 2020 WL 6114913, at \*2 (C.D. Cal. Oct. 5, 2020). Indeed, on remand, the trial court in *SEC v. Liu* deducted over \$2 million in administrative fees from the disgorgement award (e.g., marketing, legal, accounting, and offering expenses), as well as over \$3 million in expenses related to construction of a cancer treatment center (including construction, rent, equipment, tax payments, insurance costs, travel, consulting fees, and permit and license fees). 2021 WL 2374248, at \*5-7 (C.D. Cal. June 7, 2021).

**‘Reasonable Approximation’ Standard for Disgorged Profits.**

Historically, the plaintiff has the initial burden of establishing that the disgorgement figure is a “reasonable approximation” of the defendant’s unlawful profits casually connected to the alleged violation. See, e.g., *SEC v. Calvo*, 378 F.3d 1211, 1217 (11th Cir. 2004). Once satisfied, the burden of proof shifts to the defendant, who must then demonstrate why the disgorgement figure is *not* a reasonable approximation. *Id.* All doubts concerning the determination of disgorgement amounts are to be resolved against the wrongdoer. *SEC v. Platforms Wireless Intern.*, 617 F.3d 1072, 1096 (9th Cir. 2010).

In light of this, practitioners representing defendants facing disgorgement actions should affirmatively provide as much concrete evidence as possible regarding expenses and profits incurred in the allegedly fraudulent scheme. At least one post-*Liu* court has held that defendants have an affirmative duty to identify a legitimate purpose for business expenses in order for them to be deducted from any disgorgement award.” *Mizrahi*, 2020 WL 6114913, at \*2-4. More practically, Chief Counsel of the SEC’s Division of Enforcement, Joseph Brenner, recently stressed that it is incumbent on defendants to come prepared to demonstrate both the entitlement to a deduction for a legitimate expense and its amount. See *The SEC Speaks in 2020*.

**What Makes A Disgorgement Award ‘For the Benefit of Investors’?** The *Liu* court criticized the SEC’s practice of “not always return[ing] the entirety of disgorgement proceeds to investors, instead depositing a portion of its collections in a fund in the Treasury.” 140 S. Ct. at 1947. The court strongly hinted, without deciding, that situations where disgorged funds are simply deposited into the Treasury would not qualify as an award “for the victims” except in unique circumstances, such as where it is infeasible to distribute the collected funds to investors. *Id.* at 1948-49. Yet, in the wake of *Liu*, some courts have shown a willingness to accept limited evidence from the SEC on this issue absent strong pushback from the defendant. See, e.g., *Mizrahi*, 2020 WL 6114913, at \*2.

### Conclusion

The limiting principles on the SEC’s disgorgement power outlined in *Liu* remain alive and well despite the NDAA and have opened the door for meaningful and effective challenges to proposed SEC disgorgement awards.