Hedge Fund Law Report

hflawreport.com

Oct. 20, 2022

SEC Enforcement Matters

Liu Is Dead, Long Live *Liu*: *Spartan* and Disgorgement After the NDAA

By Eric Nitz, *MoloLamken LLP*

In recent years, the U.S. Supreme Court (Court) has imposed limitations on disgorgement as a remedy for securities violations. Congress, however, has pushed back against those decisions, amending the Securities Exchange Act of 1940 (Exchange Act) to undo some of the Court's decisions on disgorgement.

A recent decision in the Middle District of Florida – *SEC v. Spartan Securities Group* (*Spartan*) – illuminates how the district courts have navigated those developments and underscores ways defendants in enforcement actions can continue to challenge or limit disgorgement. This article recaps key Court decisions on disgorgement, explains Congress' response to those decisions, discusses *Spartan*'s take on disgorgement and presents the current state of disgorgement as a remedy for securities violations.

Congress Pushes Back Against *Liu* and *Kokesh*

For decades, the securities laws did not expressly authorize federal courts to impose a disgorgement remedy in civil enforcement actions. Nonetheless, the SEC had long sought – and courts had long ordered – disgorgement, reasoning that disgorgement was among the "equitable relief" that the Exchange Act authorized.

In 2017, the Court began paring back the scope and effectiveness of that disgorgement remedy. In *Kokesh v. SEC*, the Court concluded that disgorgement qualified as a "penalty" for purposes of calculating the statute of limitations. Because disgorgement was a penalty, a five-year limitations period applied.

See "Implications for Fund Managers of the Supreme Court's Ruling in *Kokesh v. SEC*" (Jun. 15, 2017).

Application of the five-year limitations period dramatically limited the amount of disgorgement that the SEC could collect, permitting courts to order disgorgement only of ill-gotten gains. The Court in *Kokesh*, however, left open the question of whether the SEC had authority to order disgorgement at all.

The Court answered that question three years later in *Liu v. SEC*. In *Liu*, the Court concluded that disgorgement did qualify as "equitable relief" under the Exchange Act. Nonetheless, the Court imposed further limitations on the disgorgement remedy. Disgorgement, the Court explained, must:

- be awarded for the victims; and
- not exceed the wrongdoer's net profits.

See "Supreme Court Scales Back SEC's Disgorgement Remedy in *Liu v. SEC*" (Jul. 16, 2020).

In 2021, Congress responded to the Court's decisions in *Liu* and *Kokesh*. Among the many provisions in the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (NDAA), Congress amended the Exchange Act to explicitly identify disgorgement as an appropriate remedy for violations of the securities laws. No longer would the SEC and the courts need to rely upon the general equitable relief language that had previously provided the statutory basis for awarding disgorgement. The NDAA also doubled the limitations period for disgorgement to ten years.

See "The SEC's New Disgorgement Powers: Questions and Consequences" (Apr. 8, 2021).

Spartan Reaffirms the Viability of Disgorgement Following the NDAA – With Caveats

Recent decisions confirm that, with the NDAA's amendments, Congress breathed new life into the disgorgement remedy and provided the SEC with a clear mandate to pursue disgorgement in securities cases.

For example, in *Spartan*, a Florida jury concluded that the defendants had made materially misleading statements or omissions in connection with the purchase or sale of securities in violation of Section 10(b) and Rule 10b-5(b) of the Exchange Act. The SEC sought a wide array of remedies, including an injunction and a bar on penny-stock trading. It also sought disgorgement and civil penalties. The court ultimately ordered disgorgement of $114,520 and assessed $250,000 in civil penalties.

The court's analysis provides new insights into how courts calculate disgorgement following the NDAA's amendments and highlights the next frontier in litigation concerning the scope of the SEC's disgorgement remedy. *Spartan* makes clear that Congress's amendments to the Exchange Act had teeth and that certain aspects of the Court's decisions in *Liu* are no longer good law.

The 10-Year Limitations Period Reigns

In *Spartan*, the court concluded that the 10-year limitations period governed the temporal scope of disgorgement. The defendants argued that the previous five-year limitations period should apply because the enforcement case was filed before enactment of the NDAA. The defendants further questioned the constitutionality of retroactively applying the 10-year limitations period from the

NDAA, asserting that doing so would violate the Constitution's Ex Post Facto Clause and the Due Process Clause.

The court disagreed, explaining that the NDAA, by its own terms, applied to all cases pending as of, or brought after, January 1, 2021. It also rejected the defendants' constitutional challenges, asserting that other courts had retroactively applied the 10-year limitations period.

See "How the SEC May Circumvent the Five-Year Statute of Limitations on Disgorgement Under *Kokesh v. SEC*" (Jul. 20, 2017).

Disgorgement Need Not Be Paid to Victims

The *Spartan* court also found it permissible under the NDAA amendments for disgorgement to be paid directly to the U.S. Treasury, rather than to specific victims. Under the original version of the Exchange Act, Congress permitted courts to order equitable relief "appropriate or necessary for the benefit of investors." *Liu* had criticized the SEC's practice of invoking that provision to seek disgorgement payable to the Treasury, rather than to victims. According to *Liu*, that practice was not consistent with the Exchange Act's requirement that disgorgement be awarded for the benefit of investors.

The *Spartan* court, however, found it permissible for disgorgement to be paid to the Treasury. The NDAA's amendments, the court reasoned, permitted courts to order disgorgement "[i]n any action or proceeding brought by the Commission." The amendments did not limit disgorgement to instances in which it was appropriate or necessary for the benefit of investors. Thus, *Liu*'s suggestion that disgorgement could be paid only to victim investors did not apply.

That conclusion is significant. After *Liu*, defendants in civil enforcement actions had a strong argument that disgorgement was an appropriate remedy only when specific, identifiable victims have suffered concrete, quantifiable harms. The interpretation of the NDAA amendments adopted by *Spartan* and other court decisions allows the SEC to continue pursuing the disgorgement remedy even when distributing the disgorged profits to investors is not feasible.

Significantly, the *Spartan* court did not base that conclusion solely on the text of the NDAA amendments – it also analyzed the question under pre-NDAA law. Balancing the equities, the court concluded that fairness required disgorgement to the Treasury even though specific victims could not be identified. Requiring the money to be paid to the Treasury, the court concluded, was fairer than allowing the gains to remain with the defendant – "a key player in a scheme to put dubious equities on the market."

The courts of appeals, however, have not yet ruled on the reasoning in *Spartan*. Although Congress did not require disgorgement to be paid for the benefit of investors when it amended the Exchange Act, courts generally presume that Congress adopted the common law meaning of the term "disgorgement." Because disgorgement was historically awarded as restitution to victims, courts of appeals might nonetheless conclude that, notwithstanding the NDAA amendments, disgorgement must be paid to identifiable victims, rather than to the Treasury.

The Court's reasoning in *Liu* would support a more restrictive view than that adopted by the *Spartan* court. Imposing penalties, the Court explained in *Liu*, was not historically among a court's equitable powers. To avoid transforming a profit remedy, such as disgorgement, into a penalty, courts would circumscribe the profit remedy in multiple ways.

One such way, *Liu* explains, was to characterize the profit remedy as a constructive trust on the wrongful gains created for the benefit of the wronged victims. Thus, *Liu*'s conclusion that disgorgement be paid for the benefit of victims appears to be rooted in historical understandings about the scope and nature of the disgorgement remedy, not just the text of the Exchange Act limiting equitable relief to instances when necessary for the benefit of victims.

For that reason, the Court might conclude that Congress intended to incorporate that historical limitation when it used the term "disgorgement" in the NDAA amendments, even though Congress did not include the "for the benefit of victims" language discussed in *Liu*.

Only Net Profits May Be Disgorged

Although the *Spartan* court concluded that the NDAA amendments obviated certain aspects of *Liu*, it found that *Liu*'s other limitations on disgorgement remain. Most significantly, the *Spartan* court continued to apply *Liu*'s requirement that only net profits could be disgorged.

Citing again the limitations traditionally placed on historical disgorgement remedies, *Liu* notes that those remedies were typically limited to "the gain made upon any business or investment, when both the receipts and payments are taken into the account." This limitation, the Court explained in *Liu*, was necessary to ensure that the disgorgement remedy was among those categories of relief typically available in equity.

The *Spartan* court applied the net-profits limitation when determining the size of the disgorgement. To that end, the court received evidence of legitimate expenses incurred by the defendants in connection with their investment activity. It then deducted those expenses from the ultimate disgorgement award.

The Contours of Disgorgement Remain in Flux

The lesson of *Spartan* is clear: The precise scope of disgorgement as a remedy for violations of the securities laws remains in flux as lower courts navigate the continuation of a tug-of-war between Congress and the Court concerning the limitations of the disgorgement remedy.

Indeed, the *Spartan* decision itself illustrates that uncertainty. The court refused to apply *Liu*'s command that disgorgement should not be assessed when it could not be paid to identifiable victims, but it nonetheless held that *Liu*'s net-profit limitation remains good law and should be applied.

Under *Liu*, however, both of those limitations – the requirement that disgorgement be paid to victims and that disgorgement not exceed net profits – arise from historical understandings about the

nature of disgorgement. Thus, a court might reason that if one of those limitations survives the NDAA amendments to the Exchange Act, they both should.

Put another way, by using the term disgorgement in the NDAA, Congress must have intended to incorporate the well-understood historical meaning of that term, along with traditional limitations on that remedy. Under that reasoning, the limitations on the disgorgement remedy that the Court described in *Liu* remain viable limitations.

Ultimately, disgorgement cannot be untethered from its equitable roots. As the Court has now made clear – twice – it will not hesitate to pare back disgorgement when it is applied in a punitive manner.

For that reason, fund managers that are targeted by SEC enforcement should continue to look to *Kokesh* and *Liu* for clues about the characteristics that might transform an order of disgorgement into a penalty and to advance arguments that those decisions continue to limit disgorgement.

Although lower courts might view the NDAA amendments as an indication that Congress intended to reverse *Liu* and *Kokesh*, courts of appeals and the Court may be more receptive to the argument that, by using the word disgorgement, Congress incorporated the well-understood historical limitations traditionally associated with that remedy.

See "What Remedies and Relief Can Fund Managers Expect in SEC Enforcement Actions?" (Jan. 10, 2019).

Eric Nitz is a partner at MoloLamken LLP, where he represents clients in white collar investigations and regulatory enforcement; complex civil litigation; and appellate litigation, briefing appeals in appellate courts across the country and in the Court.

© 2022 Mergermarket Limited. All rights reserved.