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Justices' SEC Disgorgement Ruling May Shape FCPA Matters

By **Matthew Rutter and Neal Hochberg** (May 26, 2020, 6:16 PM EDT)

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The Supreme Court is poised to decide whether the U.S. Securities and Exchange Commission may continue to pursue the disgorgement of ill-gotten gains in enforcement actions brought in federal court. The implications of this decision will likely impact resolutions of a variety of malfeasant acts.

For resolutions related to enforcement actions stemming from alleged violations of the Foreign Corrupt Practices Act, the SEC's approach may be validated, narrowed or quashed. While we expect the status quo will be maintained, with tweaks, we explore the potential outcomes and how they inform the strategy of parties during negotiations on such issues.

What is the issue?

The availability of disgorgement as an SEC remedy in enforcement actions brought in federal courts is about to have its day in court. In 2017, the Supreme Court subjected disgorgement to a five-year statute of limitations in Kokesh v. SEC.[1]

However, the oft-cited footnote 3, which stated "[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context,"[2] has led to dialogue on whether disgorgement was permissible,[3] and was interpreted by attorneys to be an invitation to challenge the SEC's use of disgorgement.

That invitation was accepted by Charles C. Liu et al., and the Supreme Court granted certiorari late last year.[4]

Subsequent to recent oral arguments in Liu v. SEC,[5] and specifically the justices' questions of the parties to the case, the answer is likely to be nonbinary. In other words, disgorgement for most cases of malfeasance will likely survive the challenge, albeit, with restrictions.

For the FCPA, there is a possibility that the guidance may be binary, however unlikely. It is possible that the restrictions placed on the use of disgorgement by the SEC render it infeasible in FCPA cases. For now, we should expect a narrow ruling, perhaps one that will remand the case to a lower court for

additional consideration.[6]

What are the key FCPA issues raised in the case brought before the Supreme Court?

Is disgorgement an available remedy to the SEC in its efforts to resolve proceedings?

To this first question, the justices indicated that yes, the SEC by statute and precedent, may pursue disgorgement. By way of inquiry during oral arguments, the justices did not accept the premise that disgorgement is not (1) an equitable remedy available to the SEC, and (2) sanctioned by Congress.

The justices' line of inquiry quickly dispensed with the idea that Kokesh established disgorgement as a penalty requiring specific statutory authority. Instead, the justices appeared to coalesce around the idea that Congress has sanctioned the SEC's pursuit of disgorgement as an equitable remedy. Disgorgement will likely live to fight another day.

Will the use of disgorgement be predicated on the ability of the SEC to remit any funds received, in whole or in part, to victims?

If yes, then the days of large FCPA settlements based primarily on disgorgement are over, and the defense bar might begin to plan for other statutory penalties that the SEC and the U.S. Department of Justice could pursue.

In oral arguments, all sides appeared to align with the idea that the SEC could pursue disgorgement if amounts awarded were, "returned to investors where feasible."[7] None of the justices indicated that a bright line would be drawn requiring returns to shareholders.

For FCPA matters, this is especially relevant. Both sides in the case cited the FCPA as an example to illustrate that disgorged amounts do not benefit victims directly; the amounts collected in the form of disgorgement have not gone back to those wronged in a tangible way.

Justice Sotomayor commented, "if the SEC got the money, it could then spend it on protecting investors, but if the Treasury's getting it — and I know you're going to say money is fungible — but, if the Treasury is getting it, we don't really know if it's being used to help investors."[8]

If the courts require remittance to victims, the SEC and DOJ might pursue other penalties that are more likely to sustain challenges.[9]

As mentioned before, other penalties include the DOJ's pursuit of criminal penalties related to each problematic payment in an FCPA case (it is not uncommon for multiple problematic payments to exist), and the SEC's pursuit of similar penalties on a per instance basis, e.g., failing to properly account for a transaction in the books and records, i.e., internal control failures.

Regardless, if oral arguments are indicative of the court's action on that matter before it, and that is no guarantee, we should expect that disgorgement will remain an option in such cases.

Finally, what amounts should be subject to disgorgement in an FCPA case?

The justices again coalesced around an idea: only net profit should be considered when disgorgement is sought. This is not necessarily a novel concept in an FCPA setting. A difference in nomenclature between

the legal and accounting contexts may give rise to a misinterpretation (i.e., what is the proper definition of net profit?).

Typically, in an accounting context, net profits would be profit after indirect expenses, such as administrative costs, depreciation and taxes are considered. Traditionally, in the FCPA context, disgorgement is based on gross profit, revenue less direct costs. Thus, the analog within the financial statements is gross profit.

Given the dialogue during oral arguments, expenses considered for disgorgement calculations will likely be limited to direct costs. Similarly, illicit payments or other items of value exchanged would likely not be permissible expenses to reduce the amount owed in a resolution based on disgorgement. In an FCPA context, this would remain consistent with current practice.

If current practice holds, disgorgement would be based solely on the revenue and direct costs stemming from business derived from the problematic payments or items of value exchanged for the sought-after revenue.

The calculation begins with the premise that disgorgement "need only be a reasonable approximation of profits causally connected to the violation."[10] Bribes or other items of value may be provided to government officials for several reasons and the associated gains calculations can be complex, such as:

- Winning business or renewals, competitive or not;
- Participating in government procurement activities, aka., pay-to-play;
- Securing higher prices in highly regulated industries such as pharma and utilities;
- Gaining rights and site-specific, resource-based licenses, such as extractive rights and drilling; and
- Avoiding taxes and fees.

Assuming the above, we can expect costs of direct labor (e.g., on-site labor, factory workers) and direct costs (e.g., raw materials) to be permissible as amounts that can be subtracted from the value received.

If other operating expenses are permissible, such as amounts that would have been incurred regardless of business won (e.g., lease payments, corporate salaries and depreciation), then disgorgement's days as a remedy may be numbered. The inclusion of such expenses would quickly reduce the calculated ill-gotten gains and the SEC's proverbial stick would be a reduced to a mere twig.

Other odds and ends to consider.

Any discussion on FCPA settlement amount would be incomplete without an acknowledgement that the SEC's view on enforcement and related penalties will also color the landscape.

For example, it is widely accepted that the SEC is increasingly vocal about its interest in pursuing individuals in FCPA cases. In a statement regarding a non-FCPA settlement, SEC Chair Jay Clayton commented:

> Speaking more broadly about the SEC's enforcement efforts that involve the misconduct of officers, directors and companies, it often is the case that the interests of ordinary shareholders — who had no involvement in the misconduct — are intertwined with the interests of offending officials and the company. For example, corporate fines often are financed with funds that could otherwise benefit shareholders, and the skills and support of certain individuals may be important to the future success of a company. At the Commission, the interests of ordinary investors are at the front of our minds and, in matters involving misconduct, we seek to serve those interests to the extent practicable while also ensuring that we remediate and deter misconduct. In addition, holding individuals accountable is important and an effective means of deterrence. I believe the settlements agreed today reflect these multiple interests and considerations.[11]

To the extent this philosophy drives a simultaneous drop in corporate enforcement actions and related penalties is an evolving story. There have been large settlements, no shortage of new cases and a focus on targeting individuals.[12]

One thing is for sure, corruption isn't going away. According to the Association of Certified Fraud Examiners, corruption remains the most common scheme in every global region.[13]

Conclusion

The recent oral arguments in Liu v. SEC indicate that agreement among the justices exists about disgorgement. We can expect an opinion that settles the questions of whether the SEC has the right to pursue it, how the SEC should treat proceeds from disgorgement resolutions, and what amounts should be pursued. If oral arguments are any guide, we should expect a result similar to the status quo.

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[1] Kokesh v. SEC, 137 S. Ct. 1635 (2017).

[2] Ibid.

[3] Theresa Gabaldon,"Opinion analysis: A statute of limitations does apply to SEC actions for disgorgement."SCOTUSblog, accessed April 24, 2020, https://www.scotusblog.com/2017/06/opinion-analysis-statute-limitations-apply-sec-actions-disgorgement/.

[4] Liu v. SEC, No. 18-1501 (2019).

[5] Oral Arguments in Supreme Court Docket No. 18-1501, Transcript of Oral Argument (March 3, 2020), accessed April 24, 2020, www.supremecourt.gov/oral_arguments/argument_transcripts/2019/18-1501_8n59.pdf.

[6] Ronald Mann,"Argument analysis: Justices seek middle ground on SEC's right to disgorgement in securities litigation."SCOTUSblog, accessed April 24,

2020, https://www.scotusblog.com/2020/03/argument-analysis-justices-seek-middle-ground-on-secs-right-to-disgorgement-in-securities-litigation/.

[7] Ibid.

[8] Ibid.

[9] Ibid.

[10] Securities and Exchange Commission v. First City Financial Corporation, Ltd., et al., Appellants, 890 F.2d 1215, 1231 (D.C. Cir. 1989).

[11] United States Securities and Exchange Commission, "Statement Regarding Agreed Settlements With Elon Musk and Tesla," accessed April 24, 2020, https://www.sec.gov/news/public-statement/clayton-settlements-elon-musk-and-tesla.

[12] "Foreign Corrupt Practices Act Clearinghouse," Stanford Law School and Sullivan & Cromwell LLP, accessed on April 24, 2020, http://fcpa.stanford.edu/statistics-analytics.html.

[13] Association of Certified Fraud Examiners, "Report to the Nations – 2020 Global Study on Occupational Fraud and Abuse, https://www.acfe.com/report-to-the-nations/2020/.