

Clients & Friends Memo

Disgorgement's Role in SEC Enforcement Actions: An Analysis of the Supreme Court's Decision in *Liu v. SEC*

June 24, 2020

On June 22, 2020, the U.S. Supreme Court threw the SEC a lifeline in the highly-anticipated decision of *Liu v. SEC*. In an 8-to-1 decision, the Justices held that the SEC may continue to obtain disgorgement in federal court, albeit in a significantly narrowed fashion.

Although the SEC has routinely sought, and often secured, disgorgement as a form of "equitable relief" in federal courts since the 1970's, commentators questioned this practice, as the SEC's authorizing statutes do not list disgorgement as an available judicial remedy. The issue came to the fore in June 2017, when the Supreme Court decided *Kokesh v. SEC*,¹ in which the Justices reasoned that disgorgement was a "penalty" subject to a five-year statute of limitations. In an attention-grabbing footnote, the Court stressed that it was not passing judgment 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 Many commentators read this to signal the Court's willingness to consider the unresolved question of the SEC's disgorgement authority. *Liu v. SEC* presented that opportunity. The Court upheld disgorgement as an available remedy, but held that disgorgement awards must be limited to wrongdoers' net profits as opposed to their gross illicit gains. The Court also cast doubt on whether the SEC may obtain disgorgement in cases where funds will be remitted to the U.S. Treasury as opposed to returned to identifiable victims.

This article analyzes the history of disgorgement prior to *Kokesh* and *Liu*, followed by an analysis of those decisions and the potential impact of *Liu* on future SEC enforcement.

A. Disgorgement's Role in SEC Enforcement

The SEC has express statutory authority to obtain "disgorgement" in enforcement proceedings it brings before its administrative law judges (ALJs). Congress granted the SEC this authority in the

¹ 137 S.Ct. 1635 (2017).

² 137 S.Ct. 1635, 1642 n.3.

Remedies Act of 1990, which expanded the SEC's administrative enforcement powers to include "an order requiring accounting and disgorgement, including reasonable interest."³

In contrast, the federal securities laws do not explicitly grant the SEC authority to seek disgorgement in federal court. Rather, the statutes generally provide that the SEC may ask courts for "any equitable relief that may be appropriate or necessary for the benefit of investors."⁴ The SEC has traditionally sought, and courts have awarded, disgorgement as an equitable remedy.

Regardless of the forum, disgorgement plays a large role in the SEC's enforcement priorities. In the last three years, the SEC obtained disgorgement awards totaling \$2.9 billion (2017), \$2.5 billion (2018), and \$3.2 billion (2019).⁵ Those figures eclipsed other monetary penalties secured by the SEC, which totaled \$832 million (2017), \$1.4 billion (2018), and \$1.1 (2019).⁶

B. Kokesh v. SEC

The Supreme Court's June 2017 decision in *Kokesh* raised a hurdle to the SEC's reliance on disgorgement as a cornerstone remedy.⁷ Given that the SEC used disgorgement to redress public wrongs and as general deterrence, the Court held that disgorgement was a "penalty" and thus subject to a five-year statute of limitations for penalties. After the decision, the SEC reported that application of the five-year statute of limitations was significant "as many securities frauds are complex, well concealed, and are not discovered until investors have been victimized over many years."⁸ The SEC Enforcement Division's annual report estimated that the decision required the agency to forego disgorgement of approximately \$900 million in 2018.⁹ In 2019, foregone disgorgement awards were approximately \$1.1 billion.¹⁰

³ 15 U.S.C. § 78u-2(e).

⁴ See 15 U.S.C. § 78u(d)(5).

⁵ U.S. Securities and Exchange Commission, Division of Enforcement, Annual Report (2017) (available at <https://www.sec.gov/files/enforcement-annual-report-2017.pdf>); U.S. Securities and Exchange Commission, Division of Enforcement, Annual Report (2018) (available at <https://www.sec.gov/files/enforcement-annual-report-2018.pdf>); U.S. Securities and Exchange Commission, Division of Enforcement, Annual Report (2019) (available at <https://www.sec.gov/files/enforcement-annual-report-2019.pdf>).

⁶ *Id.*

⁷ The SEC requested that Congress take legislative action to address the uncertainty created by *Kokesh*. There have been a number of bills introduced either eliminating or extending the statute of limitations for SEC claims. None, however, have cleared both houses of Congress.

⁸ <https://www.sec.gov/files/enforcement-annual-report-2018.pdf>.

⁹ *Id.*

¹⁰ <https://www.sec.gov/files/enforcement-annual-report-2019.pdf>.

C. *Liu v. SEC*

Disgorgement returned to the Court's attention in *Liu v. SEC*. In 2016, the SEC charged Charles *Liu* and *Xin* (Lisa) Wang with defrauding Chinese investors of a project that the couple falsely claimed met the requirements of the EB-5 Immigrant Investment Program, which is subject to federal securities laws. Fifty investors paid nearly \$27 million to fund construction of a cancer-treatment center in California. The SEC alleged that the couple misappropriated investors' funds by diverting them to overseas marketers and by paying themselves generous salaries.

In April 2017, the U.S. District Court for the Central District of California granted the SEC summary judgment, holding that the couple violated Section 17(a)(2) of the Securities Act.¹¹ The couple was ordered to pay approximately \$8.2 million in civil penalties and approximately \$26.7 million in disgorgement, both for which they were held jointly and severally liable.¹² The couple argued, unsuccessfully, that the disgorgement award should be offset by millions of dollars in purported business expenses. On appeal, the U.S. Court of Appeals for the Ninth Circuit upheld the award, holding that it would be "unjust to permit the defendants to offset against the investor dollars they received the expenses of running the very business they created to defraud those investors into giving the defendants the money in the first place."¹³

In November 2019, the Supreme Court granted the couple's petition for a writ of certiorari. In briefing, the couple argued that the omission of "disgorgement" from the statute listing the SEC's judicial remedies was intentional, as Congress wrote a separate statute expressly authorizing the SEC to obtain disgorgement in administrative proceedings.¹⁴ In response, the SEC argued that its authorizing statute granted it implicit authority to seek disgorgement as a form of "any equitable relief."¹⁵ The SEC relied heavily on lower court decisions that, since the early 1970's, held that courts could award the SEC disgorgement as an equitable remedy ancillary to an injunction.¹⁶

The Court largely sided with the SEC in its June 22, 2020 opinion. Writing for the majority, Justice Sotomayor wrote that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under §78u(d)(5)."¹⁷ The Court found that the

¹¹ 15 U.S.C. § 77q(a)(2).

¹² In its Supreme Court briefing, the SEC pointed out that the couple "transferred the bulk of their misappropriated funds to China, defied the district court's order to repatriate those funds, and fled the United States." *Liu v. SEC*, 591 U. S. ____, Slip Op. at 15 n.4 (2020).

¹³ *SEC v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018) (quoting *SEC v. JT Wallenbrock & Assocs.*, 440 F.3d 1109, 1114 (9th Cir. 2006)).

¹⁴ See 15 U.S.C. § 77h-1(e).

¹⁵ See 15 U.S.C. § 78u(d)(5).

¹⁶ E.g., *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307 (2d Cir. 1971).

¹⁷ *Liu v. SEC*, 591 U. S. ____, Slip Op. at 1.

fact that Congress used the term “disgorgement” when defining the SEC’s administrative remedies, but not when defining its judicial remedies, was of no consequence—“it makes sense that Congress would expressly name the equitable powers it grants to an agency for use in administrative proceedings,” because agencies, unlike courts, lack “inherent equitable powers.”¹⁸

The Court’s examination of equity jurisprudence revealed that “equity practice long authorized courts to strip wrongdoers of their ill-gotten gains,” with courts using various labels for that remedy—“restitution,” “accounting for profits,” or “disgorgement.”¹⁹ At their core, these profit-based remedies reflected a foundational principle: “[I]t would be inequitable that [a wrongdoer] should make a profit out of his own wrong.”²⁰ At the same time, however, the Court recognized the countervailing principle that the wrongdoer should not be punished by “pay[ing] more than a fair compensation to the person wronged.”²¹

Recognizing that there is a line between equity and punishment, the Court identified three ways in which disgorgement could be in “considerable tension with equity practices”: (1) by ordering funds deposited into the Treasury instead of disbursing them to victims; (2) by imposing joint-and-several liability on disgorgement awards; and (3) by declining to deduct even “legitimate” expenses from the receipts of fraud.²² Because the parties had not briefed these narrower issues, the Court did not decide them, but remanded them to the Ninth Circuit to consider pursuant to the following principles:

- *First*, regarding the ultimate destination for disgorged funds, the Court focused on the statutory directive that the SEC may seek equitable relief that “may be appropriate or necessary for the benefit of investors.”²³ Indeed, the Court considered this to be a “requirement” that restricts what equitable relief may be granted.²⁴ The Court recognized the SEC’s argument that it may be infeasible to return collected funds to investors in many cases. However, it was an “open question” whether returning funds to the Treasury “would indeed be for the benefit of investors.”²⁵
- *Second*, as to joint-and-several liability, the Court recognized the general principle of “individual liability for wrongful profits,” but it noted that the common law permitted joint liability for partners

¹⁸ *Id.* at 13 (second quotation from *Porter v. Warner Holding Co.*, 328 U. S. 395, 398 (1946)).

¹⁹ *Id.* at 6.

²⁰ *Id.* (quoting *Root v. Railway Co.*, 105 U. S. 189, 207 (1882)).

²¹ *Id.* at 7 (quoting *Tilghman v. Proctor*, 125 U. S. 136, 145–146 (1888)).

²² *Id.* at 12.

²³ *Id.* at 14 (quoting 15 U.S.C. § 78u(d)(5)).

²⁴ *Id.* at 16.

²⁵ *Id.* at 17.

in “concerted wrongdoing.”²⁶ The Court noted that the *Liu* case involved a married couple who each operated business entities involved in the purported scheme.²⁷ The Court left it to the lower courts to decide whether the couple should be found liable for profits as “partners in wrongdoing” or as individuals.

- *Finally*, the Court unequivocally held that “courts must deduct legitimate expenses before ordering disgorgement” in SEC enforcement actions.²⁸ To do otherwise would run contrary to longstanding equity principles. The Court remanded for the lower courts to decide whether expenses from the couple’s scheme, such as lease payments and equipment costs, had “value independent of fueling a fraudulent scheme.”²⁹

D. Impact on Future SEC Enforcement Actions

The impact of *Liu* is not so much an issue of *whether* the SEC may obtain disgorgement but *under what circumstances* it may obtain such relief. The Court’s three limiting principles may encourage the SEC, as a policy matter in future enforcement actions, to change the circumstances under which it seeks disgorgement of illicit gains. Going forward, the SEC will be required to deduct “legitimate” expenses from disgorgement amounts, something it refused to do in *Liu* and contrary to the position it often takes in cases. The SEC must also scrutinize how it applies joint-and-several liability—the requirement to do so for only “partners in wrongdoing” may be a particular challenge in insider trading cases where the SEC has traditionally held the tipper responsible for his or her tippee’s profits, even where their relationship was attenuated.

Perhaps most significant is the Court’s recognition that disgorgement be invoked only as “appropriate or necessary for the benefit of investors.” Although the Court left open the door to potentially unique circumstances, the Court cast serious doubt on whether the SEC can obtain disgorgement in situations where the money collected is merely deposited in the Treasury as opposed to returned to investors. The SEC regularly sends disgorged funds to the Treasury when identifying investors is impracticable or impossible, which is often the case in insider trading cases, market manipulation cases, and Foreign Corrupt Practices Act (FCPA) investigations. As to the latter, counsel for the SEC said at the oral argument in *Liu* that “there really is no obvious universe of individual victims from an FCPA violation.”³⁰ If the SEC is unable to justify sending disgorged funds to the Treasury, that would undoubtedly reduce the amount of disgorgement the agency is able to obtain in future enforcement actions.

²⁶ *Id.* at 17-18.

²⁷ *Id.* at 18.

²⁸ *Id.* at 19.

²⁹ *Id.* at 19.

³⁰ Transcript of March 3, 2020 Oral Argument (available at https://www.supremecourt.gov/oral_arguments/argument_transcripts/2019/18-1501_8n59.pdf) at 35:2-7.

Perhaps as a workaround to the limitations, the SEC may seek higher civil monetary penalties in judicial actions. Statutes grant the SEC has a panoply of inflation-adjusted civil penalties, and the SEC has broad flexibility under the federal securities laws to determine the amount of the civil penalty in each case.³¹ As demonstrated in *Liu*, the SEC can seek civil penalties in the amount of a defendant's illicit gain, and some securities violations (such as insider trading) provide for treble damages.³²

We may also see the SEC shift to bringing more contested actions as administrative proceedings, in which the Commission's authority to seek disgorgement has faced little challenge. However, the Court's opinion in *Liu* gives every impression that disgorgement in administrative proceedings must also be curtailed pursuant to the three equitable principles that the Court articulated: "Congress' own use of the term 'disgorgement' in assorted statutes did not expand the contours of that term beyond a defendant's net profits—a limit established by longstanding principles of equity."³³ Thus, the SEC may have little success, and may face increasing challenges, if it seeks administrative disgorgement of funds that cannot be returned to investors, relies on joint-and-several liability, or ignores legitimate business expenses that generated the funds.

The Supreme Court's decision gives companies and individuals facing SEC investigations additional tools to use when negotiating a resolution with the SEC. In the post-*Liu* landscape, companies and individuals can rely on the limitations expressed in the Court's decision to push for lower disgorgement penalties or no disgorgement altogether. For instance, those facing disgorgement requests by the SEC should demand that all legitimate business expenses be deducted from any disgorgement amount. Companies should also press the SEC regarding its planned use for disgorged funds and, if harmed investors cannot be readily identified, push back against the SEC's claim for disgorgement in that case.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Kyle DeYoung	+1 202 862 2288	kyle.deyoung@cwt.com
Lex Urban	+1 202 862 2320	lex.urban@cwt.com
Wes Wintermyer	+1 202 862 2482	wesley.wintermyer@cwt.com

³¹ <https://www.sec.gov/files/civil-penalties-inflation-adjustments.pdf>.

³² See 15 U.S.C. 78u-1(a)(2).

³³ *Liu v. SEC*, 591 U. S. ____, Slip Op. at 14.