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In '*Liu v. SEC*', Disgorgement Survives, But With Conditions

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On June 22, 2020, the Supreme Court saved the disgorgement remedy it called into question in Kokesh v. SEC*, but put the brakes on the SEC's more zealous applications that risked transforming it into an unauthorized penalty.*

The June 22, 2020 decision in *Liu v. SEC* saw the Supreme Court answer a question that has been front-and-center for securities litigators since 2017: Can federal courts order disgorgement in SEC enforcement proceedings despite lacking explicit statutory authority to do so? In an 8-1 opinion, the Court held that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under" the securities laws. 591 U.S. __, at *1. In other words, disgorgement is equitable, so long as it is done the right way. Otherwise, it would constitute a penalty, and fall outside the scope of remedies Congress authorized the SEC to seek. This has meaningful repercussions for securities defendants facing the prospect of multi-million-dollar disgorgement orders.

For decades, this distinction between a penalty and an equitable remedy did not particularly vex practitioners. Congress authorized the SEC to enforce the securities laws both through administrative proceedings and civil actions brought in federal court. In administrative proceedings, the SEC can seek civil penalties and the disgorgement of a violator's ill-gotten gains. *See* 15 U.S.C. § 78u-2(a), (e). In civil actions, it can pursue "civil penalt[ies]" and "any equitable relief that may be appropriate and necessary for the benefit of investors." *See* 15 U.S.C. § 78u(d)(3), (5). Since the 1970s, federal courts interpreted "equitable relief" to include disgorgement, which has its roots in the classical equitable remedy of restitution and was designed to "depriv[e]" a wrongdoer of "the gains of . . . wrongful conduct." *See Liu*, at *4 (quoting SEC *v. Texas Gulf Sulphur Co.*, 446 F. 2d 1301, 1307-08 (2d Cir. 1971)).

In 2017, however, the Supreme Court heard *Kokesh v. SEC*, 137 S. Ct. 1365, which asked whether disgorgement was bound by a five-year statute of limitations that binds other penalties the U.S. government may impose. At oral argument, several justices were clearly troubled by the way lower courts and the SEC had constructed the law of disgorgement without guidance from Congress or the Supreme Court. They appeared particularly skeptical of the SEC's practice of paying disgorged sums into the U.S. Treasury, as the agency had no obligation to return those funds to fraud victims—which is the heart of equitable restitution. Ultimately, the Court held that disgorgement in SEC enforcement actions "bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate." 137 S. Ct. at 1644. While it then held that "[d]isgorgement, as it is applied in SEC enforcement proceedings, operates as a penalty" for purposes of the federal statute of limitations provision, *id*. at 1645, it expressly declined to decide whether it was a penalty for all purposes. This, in effect, invited the securities defense bar to argue in every case that came after *Kokesh* that the SEC was not entitled to disgorgement because the remedy had been unmoored from its equitable foundations.

Enter Charles Liu. In 2016, the SEC brought an enforcement action against Mr. Liu, his wife, and several related entities for defrauding investors who participated in the EB-5 Immigrant Investor Program.

This program allows "noncitizens to apply for permanent residence in the United States by investing in approved commercial enterprises" focused on economic growth. *Liu*, at *4. Liu distributed an offering memorandum under the EB-5 program seeking investors to help build a cancer treatment center. According to the SEC's allegations, however, Liu misappropriated millions of dollars from the funds raised, diverted them to personal bank accounts and used them to pay impermissibly high salaries. The district court in California entered judgment for the SEC, including for disgorgement of the "full amount [Liu] raised from investors," less sums remaining in the corporate accounts, as a "reasonable approximation of the profits causally connected" to the violation. It also held each of the defendants jointly and severally liable for the award. *Id*. at 5. The Ninth Circuit affirmed, and the Supreme Court granted certiorari on November 1, 2019 to address the question it had left open in *Kokesh*.

By an 8-1 majority opinion authored by Justice Sotomayor, the Court held that disgorgement was an equitable remedy so long as it was applied like one. In doing so, it relied on two fundamental principles of equity jurisprudence: "First, equity practice long authorized courts to strip wrongdoers of their ill-gotten gains, with scholars and courts using various labels for the remedy. Second, to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims." *Id.* at *6. Applying these principles, the Court vacated the disgorgement award and remanded to the district court for another try.

The Court's guidance for remand is the real meat of the opinion. In over six pages of well-reasoned analysis, the court erected three guardrails to ensure that disgorgement awards do not veer into penalty territory.

First, since the securities laws require equitable remedies to be "for the benefit of investors," the lower courts must evaluate whether a disgorgement award—especially one that pays the disgorged funds into the U.S. Treasury to fund SEC operations—satisfies this standard. In general, "the equitable nature of the profits remedy . . . requires the SEC to return a defendant's gains to wronged investors for their benefit." *Id.* at *15.

Second, "impos[ing] disgorgement liability on a wrongdoer for benefits that accrue to his affiliates, sometimes through joint-and-several liability . . . could transform any equitable profits-focused remedy into a penalty." *Id.* at *17. Assessing whether a collective remedy is appropriate in a given case is a factual inquiry left to the lower courts. *Id.* at *18.

Third, "courts must deduct legitimate expenses before ordering disgorgement under" the securities laws, such as for items—in this case, cancer treatment equipment—that "arguably have value independent of fueling a fraudulent scheme." *Id.* at *18-19.

What do these guardrails mean in practice? Several things seem evident at this early juncture.

It will likely be harder for the SEC to obtain disgorgement in so-called "victimless" cases, where the wrongdoer reaped a benefit but investors were not harmed by the misconduct. Any disgorgement award in such cases would likely violate the requirement that it be "for the benefit of investors."

Since courts have now been cautioned against freely imposing collective or joint-and-several liability, the SEC will likely increase its efforts to show that affiliates or family members of alleged wrongdoers were co-conspirators (at the very least), or held funds as nominees of defendants. If these issues are litigated correctly, they require very fact-intensive investigations tying either third parties to the wrongdoing itself or the defendant to the funds those third parties are holding. The challenge for district and circuit courts will be to define the standards of proof required to reach assets under each theory.

Liu also sets up a three-way standoff between the government, defendants, and victims over the disposition of disgorged funds. Typically, both the SEC and the victims sue a securities defendant to recover their losses. If the SEC gets to judgment first, victims would still have a damages case if the disgorged funds were not returned and instead found their way to the U.S. Treasury. Now, however, the Court was clear that disgorged funds, wherever possible, must be returned to victims. Defendants now have a better chance of mooting claims brought by victims in parallel proceedings since the SEC should be returning all disgorged funds and any additional civil award levied against a defendant in favor of the victim would be double-dipping. *Liu* thus may have the practical impact of deterring piggy-back investor lawsuits for violations of the securities laws.

Conversely, victims may be forced to seek to intervene in SEC proceedings if they are to have a say in the disposition of disgorged funds. If investor lawsuits would be prohibitively expensive because most of the ill-gotten gains will be returned to investors via disgorgement, this may be investors' lone opportunity to contest how those illicitly obtained funds are to be distributed.

Finally, civil penalties may become much more important to the SEC. These are capped by statute at $100,000 per violation for a natural person, $500,000 per violation for entities, or the "gross amount of pecuniary gain to [a] defendant." 15 U.S.C. § 78u(d)(3)(B). Since *Liu* limits the SEC's ability to use disgorged assets to, for example, pay whistleblower awards or fund the agency's operations, *Liu,* at *15, but puts no limits on the use of civil penalties, the SEC may face difficult budgetary decisions on which activities to prioritize and fund.

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