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LIU V. SEC: SUPREME COURT CABINS SEC DISGORGEMENT REMEDY

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If the measure of a ***good*** compromise is whether it leaves both sides equally dissatisfied, as the old adage goes, then the Supreme Court's recent ruling in *Liu v. Securities and Exchange Commission* may be considered a ***great*** compromise.[1] In *Liu*, the Supreme Court vacated the lower court's judgment containing a disgorgement order, but at the same time rejected petitioners' principal claim that the Securities and Exchange Commission ("SEC") has no statutory authority to seek disgorgement. Rather, the Court made clear that the SEC is permitted to seek disgorgement as an equitable remedy in federal court enforcement actions. However, the Court also cabined the SEC's disgorgement remedy in a number of significant ways, including narrowing it only to net profits (deducting "legitimate expenses"); clarifying that the remedy should be imposed only "for the benefit" of victim-investors, not the general public; and limiting the SEC's ability to seek disgorgement on a joint-and-several basis against codefendants. The Supreme Court's ruling thus delivers only a partial—likely unsatisfying—win for each side, leaving lower courts to wade through the quagmire of how to implement disgorgement in light of the Court's general guidance in *Liu*.

Background of the Litigation

The journey to *Liu* started years ago, with challenges to the SEC's authority to file suit outside the five-year statute of limitations period in 28 U.S.C.A. § 2462. In the Supreme Court's unanimous 2013 decision in *Gabelli v. S.E.C.*, the Court held that a claim by the SEC for civil penalties "accrues" for statute of limitations purposes when the wrongful conduct occurs, not when the alleged fraud is first discovered, as the SEC had argued.[2] The Court made clear that the SEC is unlike other civil plaintiffs given it "seeks a different kind of relief," such as penalties that "go beyond compensation, [and] are intended to punish, and label defendants wrongdoers."[3] The Court, however, noted in a footnote that its ruling did not address the SEC's requests for injunctive relief and disgorgement.[4]

Naturally, the Supreme Court next addressed the statute of limitations for disgorgement actions. In *Kokesh v. S.E.C.*, decided in 2017, a

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unanimous Supreme Court held that a "claim[] for disgorgement imposed as a sanction for violating a federal securities law" is a "penalty" subject to the same five-year period of limitations considered in *Gabelli*.[5] The Supreme Court reasoned that because disgorgement is sought "to remedy harm to the public at large," "imposed for punitive purposes," and often "is not compensatory" to victims, it is a penalty that is subject to the same five-year statute of limitations.[6] The Court again noted in a critical footnote that the ruling did not opine "on whether courts possess authority to order disgorgement in SEC enforcement proceedings," effectively inviting a challenge to the SEC's authority.[7]

With that footnote, enter petitioners Charles Liu and his wife, Xin (Lisa) Wang. Liu and Wang were sued and ultimately found liable by a District Court in California of investor fraud in connection with their fraudulent solicitation of $27 million from foreign investors under the EB-5 Immigrant Investor Program. Liu had pledged to invest the bulk of the contributions into the construction of a cancer-treatment center. In reality, Liu spent nearly $20 million of investor money on marketing expenses and salaries, and diverted a sizable portion to personal accounts and to a company under Wang's control. The district court ordered disgorgement equal to the full amount raised by petitioners, less only the relatively minimal amount retained in the corporate accounts dedicated to the cancer-treatment project.[8] Petitioners appealed, among other things, the scope of the lower court's disgorgement order, and the Ninth Circuit affirmed.[9]

The Supreme Court's *Liu* Ruling

In a near-unanimous 8-1 ruling authored by Justice Sonia Sotomayor, the Supreme Court vacated the judgment and disgorgement order in the case as inconsistent with equitable principles of disgorgement, discussed below. To that extent, Liu was victorious. But so was the SEC, because the Supreme Court granted the agency clear authority to seek disgorgement. Under the Securities Exchange Act of 1934, the SEC is permitted to seek both civil penalties and "any equitable relief that maybe appropriate or necessary for the benefit of investors."[10] Recognizing that "equity practice long authorized courts to strip wrongdoers of their ill-gotten gains," the Court concluded that the SEC's statutory authorization to seek equitable remedies encompasses the disgorgement remedy.[11] In so holding, the Court rejected petitioners' arguments that, under *Kokesh*, disgorgement is necessarily a penalty outside the contours of equitable relief, despite acknowledging that the disgorgement ordered in *Kokesh* "seemed to exceed the bounds of traditional equitable principles."[12] The Court also rejected petitioners' argument that disgorgement was only available in cases

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involving a breach of trust or when Congress had expressly provided for such relief.[13] Thus, the majority declined to circumscribe the SEC's authority to seek disgorgement or to limit its application as a matter of law only to certain types of cases.

But the SEC did not emerge completely victorious. While permitting disgorgement as an equitable remedy, the Court nonetheless criticized the practice of seeking disgorgement in many instances that are "in considerable tension with equity practices."[14] The Court held that because the disgorgement remedy is "restricted . . . to an individual wrongdoer's net profits to be awarded for victims,"[15] it must be narrowed in three important ways.

First, a disgorgement award must be "for victims."[16] The Court criticized the 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."[17] The Court thus held that disgorgement cannot be used merely to "depriv[e] a wrongdoer of ill-gotten gains," and must instead be for the benefit of the victim investors.[18] The Court, however, declined to address the SEC's practice of depositing disgorgement funds with the Treasury where "it is infeasible to distribute the collected funds to investors," since the lower court had not ordered disgorgement funds to be directed to the Treasury.[19]

Second, a disgorgement award should be limited by defendant and not ordered against "multiple wrongdoers under a joint-and-several liability theory," absent a showing that co-defendants were "engaged in concerted wrongdoing."[20] While the petitioners in *Liu* are married and had not rebutted evidence of each spouse's involvement in the fraud scheme, the Court emphasized that the SEC's practice of seeking "liability on a wrongdoer for benefits that accrue to his affiliates" risks "transform-[ing] any equitable . . . remedy into a penalty" that exceeds the SEC's authority.[21]

Finally, and significantly, disgorgement must be limited to net profits, and the "courts must deduct legitimate expenses before ordering disgorgement."[22] While courts may deny "inequitable deductions" where, for example, " 'the entire profit of a business or undertaking' results from the wrongdoing," a court must first actually assess those expenses to ascertain whether they "have value independent of fueling a fraudulent scheme."[23]

Justice Thomas dissented on the basis that "disgorgement is not a traditional equitable remedy."[24] Tracing the lineage of the disgorgement remedy, Justice Thomas found that the term "disgorgement" did not appear in published cases or legal dictionaries until the 20th century, long after the nation's founding, and that it was the SEC's own actions that ushered in the term's acceptance. He also warned that the majority ruling "threatens great mischief" if its disgorgement principles do not apply equally to SEC administrative proceedings, and cautioned that the "both courts and the SEC will continue to have license to expand their own [disgorgement] power."[25] Accordingly, he would have found that the SEC lacked authority to seek disgorgement under all circumstances.

Practical Implications

The three limitations identified by the Supreme Court in *Liu* may well have significant implications on a wide array of enforcement actions brought by the SEC, as well as the forum in which the SEC chooses to bring them. For example, because the holding of *Liu* is at this point limited to civil actions, the SEC may increasingly push to bring more enforcement actions "in-house" to its administrative tribunals (which *Liu* does not address), particularly in cases where no victims can be readily identified. Any such shift may have profound consequences to litigants, since the SEC's administrative proceedings deprive a litigant of the right to a jury trial, are litigated before an administrative law judge paid by the SEC, and lack basic procedural safeguards such as broad access to discovery. It is also possible that the SEC may shift its investigative and enforcement priorities in favor of cases with identifiable investor-victims, such as Ponzi schemes and other investment adviser frauds, and away from those without easily identifiable victims, as in Foreign Corrupt Practices Act ("FCPA") and insider trading cases. That said, in cases without identifiable victims,

the SEC will contend that disgorged funds may be deposited with the Treasury on the basis that the Treasury fund benefits investors or victims of fraud generally. In insider trading cases, in particular, the SEC may also have difficulty holding a tipper liable for a remote tippee's unlawful profits as it has historically attempted to do given the Supreme Court's suggestion that this practice is "at odds" with equitable principles.[26]

Given the potentially broad limitations on disgorgement in *Liu*, it is possible that Congress may eventually step in to provide a legislative remedy. Even before the *Liu* ruling, Congress had proposed bipartisan legislation that would have statutorily conferred disgorgement authority on the agency.[27] These legislative "fixes" may be easily modified to grant the SEC the broad disgorgement authority it prefers.

Until Congress steps in or the courts further clarify the reach of *Liu*, the SEC's ability to effectively use the disgorgement remedy as a club against wrongdoers is impacted by the *Liu* ruling. As an illustration, over the last five years, the SEC has obtained disgorgement orders totaling more than $14.5 billion, which has accounted for more than 70% of all total monetary remedies obtained by the SEC.[28] Undoubtedly, the Supreme Court's ruling in *Liu* will impact the SEC's enforcement program, but only time—and likely years of additional litigation—will spell out the full implications of the decision. Until then, the only sure thing is that the Supreme Court's ruling has left both sides dissatisfied victors.

ENDNOTES:

[1] *Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936 (2020).

[2] See generally *Gabelli v. S.E.C.*, 568 U.S. 442, 133 S. Ct. 1216, 185 L. Ed. 2d 297, Fed. Sec. L. Rep. (CCH) P 97299 (2013).

[3] *Gabelli*, at 451-52.

[4] *Gabelli*, at 447 n.1 (specifying that because the District Court found the SEC's other requests timely, "those issues are not before us").

[5] *Kokesh v. S.E.C.*, 137 S. Ct. 1635, 1639, 198 L. Ed. 2d 86, Fed. Sec. L. Rep. (CCH) P 99733 (2017).

[6] *Kokesh*, at 1643-44.

[7] *Kokesh*, at 1642 n.3.

[8] *Securities and Exchange Commission v. Liu*, 262 F. Supp. 3d 957, 975-76 (C.D. Cal. 2017), aff'd, 754 Fed. Appx. 505, Fed. Sec. L. Rep. (CCH) P 100295 (9th Cir. 2018), cert. granted, 140 S. Ct. 451, 205 L. Ed. 2d 265 (2019) and vacated and remanded, 140 S. Ct. 1936 (2020).

[9] *Securities and Exchange Commission v. Liu*, 754 Fed. Appx. 505, 509, Fed. Sec. L. Rep. (CCH) P 100295 (9th Cir. 2018), cert. granted, 140 S. Ct. 451, 205 L. Ed. 2d 265 (2019) and vacated and remanded, 140 S. Ct. 1936 (2020).

[10] 15 U.S.C.A. § 78u(d)(5).

[11] *Liu*, at 6.

[12] *Liu*, at 12-13.

[13] *Liu*, at 8-9.

[14] *Liu*, at 12.

[15] *Liu*, at 6.

[16] *Liu*, at 6.

[17] *Liu*, at 14.

[18] *Liu*, at 16.

[19] *Liu*, at 16-17.

[20] *Liu*, at 9-10, 18.

[21] *Liu*, at 17-18.

[22] *Liu*, at 19.

[23] *Liu*, at 19.

[24] *Liu*, at 1 (Thomas, J. dissenting).

[25] *Liu*, at 6-7 (Thomas, J. dissenting).

[26] *Liu*, at 17.

[27] The Securities Fraud and Investor Compensation Act, S. 799, 116th Cong. (2019); Investor Protection and *capital* Markets Fairness Act, H.R. 4344, 116th Cong. (2019).

[28] SEC, Division of Enforcement, 2019 Annual Report 16 (Nov. 6, 2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

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