

## Supreme Court Upholds SEC's Disgorgement Remedy in an Opinion Likely to Spawn Further Litigation over the Particulars of the Relief

In a highly anticipated ruling, the United States Supreme Court on Monday upheld the Securities and Exchange Commission's statutory authority to seek disgorgement for violations of the securities laws. The Court's holding in *Liu v. SEC*, however, may prove to be overshadowed by the Court's discussion of how disgorgement should be calculated and awarded, which almost certainly will lead to a flurry of additional litigation in future SEC enforcement proceedings.

### Background

In federal court actions, the SEC has statutory authority to obtain both civil penalties and "equitable relief."<sup>1</sup> In enforcement cases, the SEC typically seeks, and courts frequently order, both monetary penalties and disgorgement, which requires defendants to return any profits arising from unlawful conduct. While the SEC does not have express statutory authority to obtain disgorgement, courts have traditionally awarded disgorgement on the basis of the SEC's statutory authority to seek equitable relief.

In *Liu v. SEC*, the SEC charged Charles Liu and his wife, Xin Wang, in a civil enforcement action for misappropriating millions of dollars raised from foreign investors for construction of a cancer-treatment center in the United States.<sup>2</sup> After the defendants were found liable, the district court imposed a civil monetary penalty and ordered disgorgement of almost the full amount of money they had raised. The defendants also were held jointly and severally liable for the disgorgement amount.

The defendants appealed the district court's disgorgement award to the Ninth Circuit on the ground, among others, that the court failed to deduct legitimate business expenses from the award. The defendants also argued on appeal that the SEC had no authority to seek disgorgement in federal court. This argument was based in part on the Supreme Court's 2017 decision in *Kokesh v. SEC*, which held that disgorgement is a "penalty" for purposes of 28 U.S.C. § 2462, the five year statute of limitations applicable to actions to enforce penalties.<sup>3</sup> Because the SEC's statutory authority to obtain equitable relief served as the traditional rationale for disgorgement awards, the *Kokesh* decision that disgorgement is a penalty called into question the SEC's basis for seeking disgorgement.

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<sup>1</sup> See 15 U.S.C. §§ 78u(d)(3), (5).

<sup>2</sup> *Liu v. SEC*, No. 18-1501, 2020 WL 3405845, at \*4 (U.S. June 22, 2020).

<sup>3</sup> *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

The Ninth Circuit affirmed the district court's disgorgement award and rejected the defendants' challenge to the SEC's disgorgement authority, noting that *Kokesh* expressly refused to decide the issue of whether courts can order disgorgement in SEC enforcement proceedings.<sup>4</sup>

### The Supreme Court's Decision

By a vote of 8-1, the Supreme Court unequivocally held that the SEC has the authority to pursue disgorgement in civil enforcement actions. The Court based its holding on an analysis of the equitable practice that has historically enabled courts "to strip wrongdoers of their ill-gotten gains."<sup>5</sup> In authorizing the SEC to seek "equitable relief" under 15 U.S.C. § 78u(d)(5), the Court reasoned, Congress gave the SEC the ability to ask courts to disgorge profits resulting from a defendant's wrongful conduct.<sup>6</sup>

The Court then went on to discuss three principles that limit the scope of disgorgement and that are likely to recur as issues in future cases. *First*, the Court made clear that disgorgement must be awarded for the benefit of wronged investors. This is required under both established equitable principles and the language of the statute granting the SEC the right to seek "equitable relief that may be appropriate or necessary for the benefit of investors."<sup>7</sup> The Court noted that it is an "open question" whether the SEC's practice of depositing disgorged funds with the U.S. Treasury in cases where it is not feasible to distribute the funds to wronged investors satisfies the SEC's obligations.<sup>8</sup>

*Second*, the Court noted that in multi-defendant cases, the common practice of holding each defendant independently liable for the full amount of the judgement may be impermissible. Such "joint-and-several" liability would potentially disgorge from one defendant an amount in excess of the profit that defendant actually retained, converting the disgorgement remedy into a penalty.<sup>9</sup> The Court noted, however, that joint and several liability may be appropriate in circumstances in which "partners [were] engaged in concerted wrongdoing."<sup>10</sup>

*Third*, the Court made clear that the amount disgorged may not be greater than a defendant's net profit. Because disgorgement of amounts that exceed the actual profits retained will render an award punitive, courts determining the amount of a defendant's wrongful gain must deduct legitimate business expenses from funds subject to disgorgement.<sup>11</sup>

The Court did not determine whether the disgorgement award against the *Liu* defendants ultimately satisfied each of these principles. Instead, the Court vacated the judgement and remanded the case with

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<sup>4</sup> *SEC v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018), *cert. granted*, 140 S. Ct. 451, 205 L. Ed. 2d 265 (2019), and vacated and remanded, No. 18-1501, 2020 WL 3405845 (U.S. June 22, 2020).

<sup>5</sup> *Liu v. SEC*, 2020 WL 3405845, at \*5.

<sup>6</sup> *Id.* at \*5-6.

<sup>7</sup> *Id.* at \*10 (quoting 15 U.S.C. § 78u(d)(5)).

<sup>8</sup> *Id.*.

<sup>9</sup> *Id.* at \*11.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*.

instructions to the court below to consider whether the original award was consistent with the principles articulated in the Supreme Court's opinion.<sup>12</sup>

## Practical Implications

The Supreme Court's opinion keeps in place the existing structure of SEC remedies, which typically involve monetary penalties and a separate disgorgement award that can dwarf the penalties. In 2019, by way of example, the SEC collected a total of \$1.101 billion in penalties and nearly three times that amount – \$3.248 billion – in disgorgement.<sup>13</sup>

The limiting principles articulated by the Court in the *Liu* decision, however, will likely introduce various complexities in future enforcement actions, spawning further litigation for the parties. For example, in multi-defendant cases, there will likely be meaningful fights among defendants over how much profit each defendant retained from the underlying conduct. There will also likely be extended litigation over whether SEC and district court disgorgement determinations are sufficiently precise and appropriately exclude legitimate business expenses. This type of review may also influence white collar criminal cases, and the way courts approach the calculation of loss amounts for sentencing purposes.

With respect to compensation to victims, there may be litigation over the SEC's entitlement to disgorgement where the practicality of returning funds to victims is uncertain. Side litigation by purported victims claiming entitlement to disgorged funds is also a possibility. In any event, the SEC will likely face a substantial administrative burden in complying with the requirement to return disgorged funds to victims given that in 2019, the SEC returned to harmed investors just under \$1.2 billion of the \$4.3 billion (\$3.2 billion in disgorgement and \$1.1 billion in penalties) it collected.<sup>14</sup> Indeed, the SEC may well begin to seek larger monetary penalties or decide to pursue administrative remedies to avoid the complexity and risks the *Liu* decision will introduce into the disgorgement process in federal court.<sup>15</sup>

Finally, the *Liu* decision may require courts to revisit the statute of limitations issue previously resolved in *Kokesh*. In concluding that an appropriate request for disgorgement by the SEC is an equitable remedy and not a penalty, the Court appears to have limited the holding in *Kokesh* to the specific type of disgorgement the SEC sought in that case, which was inconsistent with the principles discussed in *Liu* and was therefore punitive.<sup>16</sup> The SEC may argue in a future case that because its request for disgorgement complies with the principles in *Liu*, the disgorgement remedy is equitable rather than punitive and, thus, is not governed by § 2462's five-year statute of limitations.

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<sup>12</sup> *Id.* at \*12.

<sup>13</sup> See SEC Division of Enforcement 2019 Annual Report, at 16, <https://www.sec.gov/enforcement-annual-report-2019.pdf>.

<sup>14</sup> See *id.* at 17.

<sup>15</sup> As Justice Thomas, the lone dissenter in *Liu*, noted, it is unclear whether the new limitations on disgorgement will apply to administrative proceedings. *Liu v. SEC*, 2020 WL 3405845, at \*15 (Thomas, J., dissenting).

<sup>16</sup> In distinguishing *Kokesh*, the Court said: "To be sure, the *Kokesh* Court evaluated a version of the SEC's disgorgement remedy that seemed to exceed the bounds of traditional equitable principles. But that decision has no bearing on the SEC's ability to conform future requests for a defendant's profits to the limits outlined in common-law cases awarding a wrongdoer's net gains." *Id.* at \*8.

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