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SEC Disgorgement Lives to See Another Day After Supreme Court's *Liu v. SEC* Ruling

On June 22, 2020, in *Liu v. SEC*, the Supreme Court affirmed in an 8-1 ruling that the Securities and Exchange Commission may continue to pursue disgorgement awards under the federal securities law provided that the award is capped at the defendant's net profits, and further, provided that the award is made for the benefit of wronged investors. In so holding, the Court struck a middle ground by narrowly preserving one of the most powerful enforcement mechanisms available to the agency but limiting the awards more closely than the awards the SEC has sought over the years.

Background

The case arises from an SEC enforcement action alleging that petitioners Charles Liu and Xin Wang had defrauded foreign investors seeking green cards through the EB-5 Immigrant Investor Program. The SEC alleged that petitioners misappropriated $26.7 million in investor funds earmarked for the development of a cancer treatment center. The district court held that petitioners violated the Securities Act of 1933 through false statements in their offering documents and ordered i) a civil monetary penalty of $8.6 million, ii) a disgorgement of $26.7 million, which was the amount of funds raised from investors, and iii) an injunction from soliciting future EB-5 funds.

Petitioners appealed to the 9th Circuit, arguing that disgorgement was punitive in nature and hence constituted a penalty which Congress has not authorized the SEC to seek in federal court actions. Petitioners claimed that the SEC may only seek *equitable* remedies in conjunction with civil monetary penalties that are authorized by Congress. Petitioners relied on recent Supreme Court precedent from *Kokesh v. SEC*, which held that SEC disgorgement should be considered a "penalty" for statute of limitations purposes, but expressly declined to rule whether SEC disgorgement was a permissible remedy for certain broader purposes.

The 9th Circuit held that the disgorgement was appropriate according to Circuit precedent, noting that the Supreme Court had expressly refused to make a ruling on this issue in *Kokesh*. Petitioners filed a petition for certiorari, which the Supreme Court granted in order to determine whether disgorgement is a penalty, and thus not permissible, or a form of equitable relief, which is permissible.

The Supreme Court Opinion

The Court ruled that disgorgement can be viewed as an equitable remedy under traditional legal analysis and need not be viewed as a penalty if the disgorgement meets traditional tests of equitable relief. Under the Court's analysis, such relief would be allowed pursuant to the relevant authorizing statute within traditional equity standards if certain boundaries are observed. Most significantly, the award must be restricted to an individual's net profits, and the amounts recovered must be used to make whole the victims. Justice Sotomayor, writing for the near-unanimous bench, held that disgorgement has long been considered an equitable remedy, sometimes labeled as restitution.

Importantly, the Court held that the award must be "tethered to a wrongdoer's net unlawful profits" to avoid classification as a punitive measure. The Court specifically noted that SEC disgorgement orders have, at times, failed to satisfy proper limits by depositing disgorgement into the United States Treasury and not returning the disgorgement awards to victims. The Court also identified two other problems with SEC disgorgement orders: First, the SEC has often imposed joint and several liability on multiple defendants, and the Court noted that absent an appropriate basis for imposing such joint liability, doing so would be punitive rather than remedial. The Court also noted that it is not appropriate to decline to deduct any legitimate expenses incurred by the defendant when calculating the value of the defendant's ill-gotten gains.

The Court declined to decide on the specific factual application of these limitations to the facts of this case, or rule that the petitioners' disgorgement was an unlawful penalty. Instead, the Court remanded the case to the lower courts for inquiry, and action consistent with the above-stated principles.

Impact on SEC Enforcement and Lower Courts

While *Liu* granted a narrow victory to the SEC by upholding the use of disgorgement awards, *Liu* will significantly shift the SEC's disgorgement practice by requiring the agency to comply with the limitations discussed above. As the Court acknowledged, the SEC's past disgorgement awards (which had gone unchallenged) may have stepped outside the bounds of equitable relief and into punitive territory. In light of *Liu*, lower courts will more closely scrutinize disgorgement amounts to ensure that they are calculated to avoid classification as a punitive measure. Moreover, the courts will have to determine whether disgorgement proceeds are awarded for the benefit of victims. The Court chose not to address whether practical issues of distributing proceeds of disgorgement to those harmed can overcome a requirement to use disgorged amounts for investors, and lower courts will have to grapple with the open question as to whether it is ever appropriate for such proceeds to be remitted to the U.S. Treasury if disbursement to victims is not feasible.

The limitations imposed on the SEC's use of disgorgement proceeds may have a corollary impact on the operations of the SEC. Such proceeds have been used by the SEC to fund some whistleblower awards, and the result could be an eventual reduction in the amount of funds available for such awards.

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