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Supreme Court: SEC Disgorgement Survives, but with Limitations

In its 8-1 decision in *Liu v. SEC*,¹ the U.S. Supreme Court upheld the SEC’s authority to obtain disgorgement as an equitable remedy under the Securities Exchange Act of 1934, as amended, 78 U.S.C. §78a et seq, but limited the scope of the remedy. The Supreme Court directly addressed the issue that the Court in *Kokesh v. SEC*² did not address, and held that through its power to award equitable relief, the SEC may seek disgorgement, provided it does not exceed a wrongdoer’s net profits and is awarded to victims. In other words, disgorgement remains a quiver in the SEC arsenal, but with limitations.

Background

Congress authorized the SEC to enforce the securities laws and to punish securities fraud through administrative and civil proceedings. In administrative proceedings, the SEC can seek limited civil penalties and “disgorgement.” In civil actions, the SEC can seek civil penalties and “equitable relief” under 15.U.S.C. §78u(d)(5), which provides:

In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors. [emphasis added]

¹ *Liu v. SEC* is available [\[here\]](#)

² *Kokesh v. SEC* is available [\[here\]](#)

Congress did not define what falls under the umbrella of “equitable relief,” so it was left to the courts to consider which remedies the SEC may impose as part of its power to seek equitable relief.

As far back as *SEC v Texas Gulf Sulphur Co.*,³ courts determined that the “SEC had authority to obtain what it called ‘restitution’ meaning ‘profits’ that ‘merely deprive[___]’ a defendant of ‘the gain of wrongful conduct.’” The SEC has continued to request this remedy (which later was referred to as disgorgement) and courts have continued to award it.

Kokesh arrived almost 50 years later, at which point the Supreme Court determined that disgorgement constituted a “penalty” for the purpose of 28 U.S.C. §2462, which established a five year statute of limitations for commencing “an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture.” However, the Court in *Kokesh* did *not* address whether a §2462 penalty, nevertheless, can qualify as “equitable relief under §78u(d)(5), given that equity never ‘lends its aid to enforce a forfeiture or penalty.’” The Court in *Kokesh* specifically cautioned that its decision should *not* be interpreted “‘as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings.’”

On June 22, 2020, the Supreme Court held in *Liu v. SEC*, that a disgorgement award that does not exceed a wrongdoer’s net profits and is awarded for victims qualifies as equitable relief that is permissible under §78u(d)(5). In so doing, the Court resolved the question left unanswered in *Kokesh* and made clear that *Kokesh* does not preclude the SEC from recovering ill-gotten gains from wrongdoers, but imposed certain limitations.

Facts in Liu

Succinctly stated, the SEC brought an action against petitioners Charles Liu and his wife, Xin Wang, alleging they defrauded foreign nationals in connection with a solicitation of \$27 million under an EB-5 Immigration Investor Program. Liu sent a private offering memorandum to prospective investors, pledging that the bulk of any contributions would go toward the construction costs of a cancer treatment center, less certain administrative fees. An SEC investigation revealed, however, that Liu spent nearly \$20 million of investor money on ostensible marketing expenses and salaries and diverted a sizable portion of the funds raised to personal accounts and to a company under Wang’s control.

The district court ruled in favor of the SEC and found that Liu and Wang violated the terms of the offering documents by misappropriating millions of dollars and ordered disgorgement equal to the full amount petitioners had raised from investors, less the amount that remained in the corporate accounts for the project. Petitioners objected and claimed that the disgorgement award failed to account for their business expenses, but the district court disagreed, concluding that the sum was a “reasonable approximation of the profits causally connected to [their] violation” ... and ordered petitioners jointly and severally liable for the full amount the SEC sought.

³ 446 F.2d 1301 (2nd Cir. 1971)

The Ninth Circuit affirmed, and the Supreme Court granted certiorari. Relying on *Kokesh*, petitioners argued that disgorgement was a penalty (albeit for statute of limitations purposes), and therefore, the district court lacked the power to order disgorgement as an equitable remedy in an SEC enforcement action. The Supreme Court granted certiorari to determine whether the SEC's authority to seek equitable relief under §78u(d)(5) includes the authority to seek disgorgement beyond a defendant's net profits from wrongdoing.

The Supreme Court's Decision in *Liu*

The Supreme Court held that notwithstanding *Kokesh*, disgorgement is a form of equitable relief authorized by §78u(d)(5). The Supreme Court found that the SEC is entitled to seek disgorgement that does not exceed a wrongdoer's net profits and is awarded to benefit victims. The Court explained that courts have long been authorized to strip wrongdoers of their ill-gotten gains in equity, but that in order to avoid transforming the equitable remedy into an impermissible punitive sanction, courts need to restrict the remedy to an individual wrongdoer's net profits to be awarded for victims.

In *Liu*, the Court makes clear that to comport with equitable principles and avoid transforming it into a penalty outside of a court's equity powers, disgorgement awards must: (1) return funds to victims, (2) impose liability on a defendant based on his/her own wrongful conduct, as opposed to a theory of joint-and-several liability, and (3) deduct legitimate expenses from the disgorgement award. The Court held disgorgement will stand as relief available in equity, if restricted to "net profits from wrongdoing after deducting legitimate expenses... when assessed against only culpable actors and for victims..."

Repercussions of *Liu*

Going forward, the SEC will have to consider modifications when it seeks disgorgement. For example, in the context of an insider trading case where it is not feasible to ascertain the identity of defrauded investors the SEC typically will deposit a portion of disgorgement funds collected into the U.S. Treasury. Arguably, this is not "appropriate or necessary for the benefit of investors," as required by §78u(d)(5). This practice may need adjustment.

Under the reasoning in *Liu*, disgorgement is justified from multiple parties when the parties' misconduct is sufficiently intertwined to justify more than the individual's own conduct. Accordingly, the SEC's practice of routinely imposing joint-and-several liability by seeking disgorgement from nontrading tippers for downstream tippee profits also may need revision.

Finally, under *Liu*, courts must deduct "legitimate expenses" before ordering disgorgement. In other words, disgorgement awards cannot exceed the wrongdoer's net gains. The SEC's practice of seeking recovery of gross profits also will have to be revisited.

Conclusion

While perhaps not a perfect victory, the SEC has succeeded in preserving one of its most significant and impactful remedies in federal court. However, it remains to be seen to what

extent defendants will attempt to apply the limitations in *Liu* to administrative proceedings, where the disgorgement remedy is available to the SEC by statute.

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If you have any questions concerning any disgorgement awards in any SEC action or administrative proceeding or any questions concerning disgorgement in general, please contact Meryl Wiener, any of the undersigned, or your regular Warsaw Burstein attorney.

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