CLIENT ALERT

SEC Disgorgement Survives Post-*Kokesh* Attack in Highly Anticipated Supreme Court Ruling

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On June 22, 2020, the U.S. Supreme Court declined to completely upend a crucial enforcement remedy in holding that the Securities and Exchange Commission (SEC) may seek disgorgement of ill-gotten gains through its power to obtain "equitable relief" under 15 U.S.C. § 78u(d)(5). Delivering the opinion for an 8-1 majority, Justice Sotomayor wrote in *Liu v. SEC*, No. 18-1501 (U.S. June 22, 2020), that longstanding equitable principles allow for the SEC's use of disgorgement, although with limitations that are certain to have ripple effects across the regulator's enforcement program. Justice Thomas dissented.

This decision follows the Court's landmark 2017 ruling in *Kokesh v. SEC*, which deemed disgorgement a "penalty" for purposes of the five-year statute of limitations period applicable to penalties, but explicitly left open the fundamental question of whether the SEC may nevertheless seek disgorgement in the first instance as an equitable remedy.[1] Following *Kokesh*—and its rejection of the SEC's long-running conception of disgorgement—many commentators foretold a complete rollback of disgorgement by the Court. Others adopted a more nuanced approach.[2] *Liu* leaves the remedy intact, although with the expansive caveats "that a disgorgement award does not exceed a wrongdoer's net profits and is awarded for victims."[3] The contours of these limitations, which were not previously part of the SEC's interpretation of its

[1] *Kokesh v. S.E.C.*, 581 U.S. ___ (2017).

[2] We analyzed those nuances and the Court's *Kokesh* decision generally, predicting more understated albeit meaningful long-term effects, in a separate Client Memorandum dated June 6, 2017, which is available here.

[3] *Liu*, No. 18-1501 at 4.

disgorgement powers, will initially be determined by lower courts and will have broad implications for future enforcement actions.

Notwithstanding the limitations previously announced in *Kokesh*, the stakes were high in *Liu*. Even post-*Kokesh*, disgorgement has remained the primary tool for the SEC's imposition of monetary remedies, and has even expanded in the years following the decision. Not only have SEC disgorgement orders increased from $2.96 billion in FY 2017 to $3.25 billion in FY 2019, but disgorgement totals continue to dwarf annual civil penalty totals ($832 million in FY 2017 and $1.1 billion in FY 2019).[4] Disgorgement has similarly remained an indispensable remedy for other enforcement agencies, including the Commodity Futures Trading Commission (CFTC) and the Federal Communications Commission (FCC).

Liu itself arose from a civil enforcement action against Charles Liu and his wife, Xin (Lisa) Wang. The SEC's investigation revealed that Liu solicited nearly $27 million from foreign investors through the EB-5 Immigrant Investor Program, which provides a pathway for noncitizens to obtain permanent residence through investments in certain approved commercial enterprises.[5] The private offering memorandum sent by Liu to his eventual investors stated that their investments would be used for construction of a cancer treatment center, as well as small administrative fees. In reality, only a small fraction of the funds were put toward "a lease, property improvements, and a proton-therapy machine for cancer treatment," while nearly $20 million was spent on "marketing expenses and salaries," along with the diversion of significant sums to personal accounts and a company under Wang's control.[6]

The district court found for the SEC and ordered disgorgement for the full amount obtained from investors, less the $234,899 remaining in the project's corporate account. The Ninth Circuit affirmed, holding that "the proper amount of disgorgement in a scheme such as this one is the entire amount raised less the money paid back to investors."[7] The Supreme Court vacated and remanded, holding that § 78u(d)(5) allows disgorgement, but not "beyond a defendant's net profits from wrongdoing."[8]

The Court's task in *Liu* was to determine whether disgorgement constitutes "equitable relief" under § 78u(d)(5); i.e., "whether [disgorgement] falls into those categories of relief that were typically available in equity."[9] In order to resolve this question affirmatively, Justice Sotomayor turned to over 150 years of jurisprudence stating that equity courts are authorized—via remedies referred to in various contexts as accounting, restitution, or disgorgement—"to strip wrongdoers of their ill-gotten gains."[10] Simply put, "it would be inequitable that a wrongdoer should make a profit out of his own

4 *See* SEC Division of Enforcement 2019 Annual Report (SEC Annual Report), available here.
5 *Liu*, No. 18-1501 at 4.
6 *Id.*
7 *Id.* at 5.
8 *Id.*
9 *Id.* (internal citation and quotation marks omitted).
10 *Id.* at 6.

wrong."[11] Thus, SEC disgorgement survives as an equitable remedy. There is a limit to these equitable principles, however, as a wrongdoer "should not be punished by paying more than a fair compensation to the person wronged," and any award beyond profits would improperly "transform[] an equitable remedy into a punitive sanction."[12]

The Court's discussion of these limitations is certain to become a point of contention in the coming years. As Justice Sotomayor wrote, "courts have occasionally awarded disgorgement in three main ways that test the bounds of equity practice: by ordering the proceeds of fraud to be deposited in Treasury funds instead of disbursing them to victims, imposing joint-and-several disgorgement liability, and declining to deduct even legitimate expenses from the receipts of fraud. The SEC's disgorgement remedy in such incarnations is in considerable tension with equity practices."[13]

In effect, *Liu* adopts the propositions that 1) disgorgement must be used to compensate victims; 2) joint-and-several disgorgement is improper; and 3) legitimate expenses must be deducted from disgorged funds. While the Court declined to formally expand upon these propositions, the decision announced "principles that may guide the lower courts' assessment" of future cases and cautioned against disgorgement awards that run afoul of these principles.[14] Each could have far-reaching implications for future enforcement actions.

First, as the Court put it, "[t]he equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for their benefit."[15] The decision goes on to express hesitancy over—if not outright hostility toward—disgorgement that directs proceeds to the Treasury, a common feature of SEC disgorgement orders, even if distribution to investors is infeasible. In other words, absent the practicability of returning disgorgement fees to investors, the legitimacy of a disgorgement order itself could be called into question. This could prove particularly meaningful in, for example, Foreign Corrupt Practices Act (FCPA) and insider trading actions, where the SEC has traditionally sought disgorgement but the identification of victims to be compensated may be impossible. It is worth noting, however, that the SEC already responded to *Kokesh* by indicating publicly that it has "shifted resources to those investigations which hold the most promise for returning funds to investors."[16]

Second, *Liu* addressed the SEC approach of imposing disgorgement liability for benefits that accrue to a wrongdoer's affiliates. Under the equitable framework at the heart of the decision, this practice is improper as it is "at odds with the common-law rule requiring individual liability for wrongful profits" and "would transform any equitable profits-focused remedy into a penalty."[17] In other words, joint-and-several disgorgement has ended, although the Court acknowledged

[11] *Id.* (internal citation and quotation marks omitted).
[12] *Id.* at 6-7 (internal citation and quotation marks omitted).
[13] *Id.* at 12.
[14] *Id.* at 14.
[15] *Id.* at 15.
[16] *See* SEC Annual Report.
[17] *Liu*, No. 18-1501 at 19.

that joint liability for "partners engaged in concerted wrongdoing" may have survived.[18] The end of joint-and-several disgorgement could have the most immediate implications in insider trading cases, in which the SEC has imposed disgorgement on tippers of downstream tippees' profits even when there was no concerted plan between them. It will also significantly complicate disgorgement calculations in already complex multiparty frauds, and place primary importance on determining whether actors constitute "partners" under the Court's guidance.

Finally, the Court required that "courts must deduct legitimate expenses before ordering disgorgement,"[19] providing a strong foundation for arguments that sophisticated practitioners have been making for years. In *Liu*, the district court somewhat offhandedly "declined to deduct expenses on the theory that they were incurred for the purposes of furthering an entirely fraudulent scheme."[20] But Justice Sotomayor makes it clear that this theory requires an actual assessment of whether expenses are legitimate, and "some expenses from [Liu's] scheme went toward lease payments and cancer-treatment equipment," which "arguably have value independent of fueling a fraudulent scheme."[21] In the complex enforcement actions typical of the SEC and other regulators, the untangling of legitimate expenses and related determinations are now likely to take on even more prominence.

Although it has not issued a formal statement at the time of this writing, the SEC appears to be taking an optimistic view of *Liu*, commenting through a spokesperson that the decision "allows us to continue to strip wrongdoers of their ill-gotten gains and return money to its rightful owners, following the Court's direction to ensure that our efforts embody principles of equity and fairness."[22]

In sum, while the question of whether the SEC can seek disgorgement has been settled, Justice Sotomayor and the majority of the Court in *Liu* imposed significant limitations on the SEC's conception and use of its disgorgement powers. Following the theme it established in *Kokesh*, the Court held that the SEC's current use of its disgorgement authority—typically seeking gross profits, disgorgement on a joint-and-several basis, and often remitting disgorged funds to the Treasury rather than to investors—is akin to an improper penalty and must be limited as outlined in the decision in order to survive. The SEC's adaptation to these changes and lower courts' interpretations are sure to evolve and are likely to remain unsettled for years.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *See High Court Preserves SEC Disgorgement, With Limits*, Law360 (June 22, 2020), here.

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