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Report from Washington

Supreme Court Considers Whether to Limit SEC's Right to Seek Disgorgement in Civil Proceedings

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"[W]hat is your position with respect to that broader question of who gets the money? Why is it the Treasury? It's not the SEC getting the money."
– Justice Sotomayor

The Supreme Court heard oral arguments in *Liu v. Securities and Exchange Commission*, No. 18-1501, on Tuesday, March 3, 2020, to decide whether existing legislation authorizes the SEC to seek disgorgement of profits as "equitable relief" in district court proceedings when the Commission enforces the Securities Act of 1933 and the Securities Exchange Act of 1934. Although several justices observed that disgorging profits was a traditional equitable remedy, many expressed concern about the punitive nature of the SEC disgorgement in the instant case. In particular, the justices expressed concern that defendants might be forced to disgorge all money they received (and not just profits) and that many disgorgement payments are kept by the government and not returned to victims.

The SEC obtains billions of dollars in disgorgement every year, requiring defendants in civil securities suits to disgorge the ill-gotten gains of their misconduct. The practice of seeking disgorgement has been business-as-usual for SEC attorneys since the early 1970s, but the statutory authorization for this practice has been called into question. Congress has authorized the SEC to seek disgorgement in its own administrative proceedings (15 U.S.C. § 78u-2(e)), but has not expressly authorized disgorgement when the SEC seeks such relief in federal court. Instead, Congress has authorized the SEC to seek a range of remedies, including "any equitable relief that may be appropriate or necessary for the benefit of investors," in district court proceedings. (15 U.S.C. § 78(u)(d)(5)).

The SEC often seeks disgorgement in cases where the Commission believes defendants have defrauded or deliberately deceived investors. In 2019, the SEC obtained $3.2 billion in disgorgement, compared with $1.1 billion in civil penalties. In 2019, the SEC returned 37% of disgorged profits to harmed investors, with the remainder of disgorged funds dispersed to the U.S. Treasury. Disgorgement thus primarily operates as a deterrent to companies and individuals who mislead and deceive investors. The *Liu* case demonstrates that disgorgement amounts can greatly exceed civil penalties.

The Court recently held in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), that disgorgement of profits is a penalty, and not an equitable remedy, in the context of statutes of limitations. The unanimous *Kokesh* Court did not reach the question of whether the SEC can seek disgorgement in district court proceedings, the question that has now ripened.

Case Background

"But is your argument that disgorgement is never possible or that disgorgement has been interpreted too broadly by the courts?"

– Justice Alito

Petitioners Charles Liu and his wife, Xin Wang, raised approximately $27 million from Chinese investors as part of the EB-5 Immigrant Investor Program. The EB-5 Program enables foreign citizens to obtain U.S. visas in exchange for investments in U.S. projects. Liu and Wang raised funds to construct and run a cancer treatment facility in California, with the bulk of the money earmarked for construction and not for Liu and Wang's salaries. While some progress was made on the facility, it was not ultimately built and much of the money was spent on Liu and Wang's salaries and other marketing costs. The SEC sued Liu and Wang for violating Section 17(a)(2) of the Securities Act of 1933, and United States District Court for the Central District of California granted the SEC's motion for summary judgment. In granting the motion, the district court found that Liu and Wang misappropriated the bulk of the investment, paying themselves $8.2 million in salaries and inappropriately paying $12.9 million to marketing firms. The district court enjoined Liu and Wang from participating in the EB-5 Program again, imposed penalties of $8 million (the amount of the salaries Liu and Wang had received), and ordered disgorgement of the remaining $19 million that Liu and Wang took from investors. The district court described the sum as a reasonable proxy of petitioners' profits and declined to offset that figure by petitioners' legitimate business expenses. Liu and Wang appealed to the Ninth Circuit Court of Appeals, and a unanimous panel affirmed the district court's order. The Ninth Circuit rejected defendants' argument that they should not have to disgorge $4.5 million that they appropriately spent on property development costs. Petitioners filed a writ of certiorari, which the Supreme Court granted to address the question of whether the SEC may seek disgorgement as an equitable remedy.

The parties disagree about whether Congress has authorized the SEC to seek disgorgement. Petitioners point to 15 U.S.C. § 78u(d)(5), which authorizes the SEC to seek several remedies, including "equitable relief" (but not expressly defined to include disgorgement), when it litigates in district court. Petitioners note that, under *Kokesh*, disgorgement is not a form of equitable relief, and so disgorgement cannot be an "equitable remedy" under § 78u-2(d)(5). Because Congress gave the SEC a range of enumerated remedies (including civil penalties and injunctions), they argue, the omission of disgorgement suggests that Congress did not intend to authorize the SEC to seek disgorgement in federal court. Petitioners also point to 15

U.S.C. § 78u-2(e), expressly authorizing the SEC to seek disgorgement in its own administrative proceedings, as proof that Congress did not intend the SEC to have this ability in court. Further, Congress has authorized other agencies, such as the Consumer Financial Protection Bureau, to seek disgorgement in district court, suggesting that the lack of this grant of authority to the SEC is intentional. Petitioners highlight the punitive, rather than compensatory, nature of disgorgement (because the funds often do not go to harmed investors) to argue that it is not an analog to any equitable remedy.

The SEC cites a number of lower court decisions as evidence that disgorgement falls within the "equitable relief" authorized by § 78u(d)(5). The Commission further argues that Congress has implicitly authorized disgorgement through a number of other statutes. For example, the Insider Trading Act of 1988 contemplates that courts consider previously-disgorged amounts when awarding damages in private insider trading suits. The SEC points to a range of other statutes, including the Private Securities Litigation Reform Act and the Sarbanes-Oxley Act, which appear to contemplate disgorgement of funds. The SEC argues that Congress was aware of the SEC's disgorgement practice when it passed those statutes and therefore implicitly ratified the Commission's authority to seek disgorgement in civil suits. The Commission also analogizes disgorgement to long-standing equitable remedies such as restitution and accounting of profits, arguing that courts of equity have long awarded similar relief.

Oral Argument Highlights

"Would it be appropriate for this Court to say that's the rule; namely, that it has to be returned to investors where feasible?"
– Justice Kavanaugh

The oral argument focused heavily on the seemingly punitive nature of the disgorgement the SEC sought in this case and whether changes to the disgorgement calculation might more closely align disgorgement with traditional equitable remedies. The justices asked whether disgorged funds should be returned to investors and appeared concerned that in this case, the SEC sought to disgorge all of the investments petitioners received and not just their profits. The justices maintained that depriving wrongdoers of their profits was a traditional equity practice, but appeared concerned about the Court's role in dictating the appropriate remedy here.

Justice Alito asked petitioners if the remedy would be equitable if it were limited to net profits instead of the entire amount defendants took in from investors. Petitioners' counsel responded that a similar remedy in equity would be based on profits, but that that remedy would normally only be available for a breach of fiduciary duties, which the SEC did not plead or prove in this case. When Justice Kavanaugh followed up on the relevance of disgorgement's calculation as revenues or profits, petitioners' counsel noted that there is not

"Is it not an equitable principle that no one should be allowed to profit from his own wrong? That's not an equitable principle?"
– Justice Ginsburg

even agreement among the circuit courts as to what disgorgement is and how it should be calculated and urged that Congress, not the Court, should be responsible for crafting the scope of disgorgement and how it should be calculated.

Justice Kavanaugh also asked if the result would change if profits were dispersed to investors (instead of the Treasury), and petitioners' counsel acknowledged that that would address one of the main inconsistencies with a traditional equitable remedy. Nonetheless, counsel for petitioners insisted that the remedy the SEC sought "was clearly a penalty and clearly inconsistent with *Kokesh*." Regarding *Kokesh*, Justice Ginsburg observed that the context of that case (the statute of limitations) was vastly different from the equitable remedy question in *Liu*, noting the equitable principle that wrongdoers should not profit from their wrongs.

Counsel for the SEC downplayed the significance of *Kokesh*, pointing the Court to another case, *Kansas v. Nebraska*, 135 S. Ct. 1042 (2015), where disgorgement was ordered as an equitable remedy. Justices Sotomayor and Gorsuch asked how and why the SEC chooses to return money to investors or distribute it to the Treasury. SEC counsel explained that while the Commission attempts to return disgorged funds to investors, there are some cases, like those involving the Foreign Corrupt Practices Act, where there's not always an individual victim who should receive the disgorgement proceeds. Justice Kavanaugh also questioned whether the Supreme Court should announce a rule on how disgorgement is calculated, or leave it to district courts to decide.

Justice Ginsburg probed the SEC's position that administrative proceedings were an inadequate substitute for district court proceedings, noting that the Commission could take an administrative order to a district court for enforcement if needed. Counsel for the SEC responded the Commission often proceeds in district court when it has doubts about a defendant's compliance, allowing for a more streamlined enforcement action.

Potential Implications

A loss for the SEC would remove one of the Commission's most potent enforcement tools, and could shift the leverage in discussions between the SEC and parties it is investigating. Indeed, twenty three states and the District of Columbia joined an amicus brief arguing that the SEC's ability to seek disgorgement is critical to efforts to deter fraud. Although the SEC would still be able to seek disgorgement in its own administrative proceedings, the Commission notes that its own administrative law judges lack the same equitable powers to enforce disgorgement orders as federal district court judges. For example, an SEC ALJ cannot freeze a defendant's assets or appoint a corporate monitor. The SEC could also still

"[H]ow realistic do you think it is to assume that when Congress used this term equitable relief, Congress meant to incorporate every curlicue of old equity jurisprudence?"
– Justice Alito

seek and obtain penalties equal to a defendant's "personal gain" but would lose disgorgement orders which often greatly exceed personal gain penalties. The SEC would also lose the ability to charge prejudgment interest, which can amount to tens of millions of dollars in certain cases, as prejudgment interest is only payable on disgorgement and not civil penalties.

Should the Supreme Court rule against the SEC in *Liu*, we expect some measure of short-term disruption to the SEC's enforcement program. But we anticipate that Congress would act to provide express statutory authority for disgorgement—and there are in fact two draft bills advancing in Congress—in a manner that may actually extend the statutory limitations period for disgorgement to as long as ten years. And in the interim, the SEC could be expected to pursue more cases in an administrative forum, where it has express statutory authority to pursue disgorgement.

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