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Liu v. SEC—Supreme Court Refines SEC's Equitable Remedy of Disgorgement

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On June 22, 2020, the U.S. Supreme Court (the "Court") ruled 8–1 in favor of the Securities and Exchange Commission's ("SEC") right to seek disgorgement of ill-gotten gains in the landmark case of *Liu v. SEC*, 591 U.S. __ (2020). Although the Court found that the SEC is entitled to seek equitable relief in the form of disgorgement, it curbed the SEC's enforcement powers by imposing limitations on the scope of such relief. Namely, the Court held that a disgorgement award that (i) does not exceed a wrongdoer's net profits and (ii) is awarded for the benefit of victims, is equitable relief permissible under Section 78u(d)(5). As a result, the Court vacated and remanded the case back to the Ninth Circuit for further review.

Background on SEC's Ability to Seek Equitable Relief Through Disgorgement

There is no express statutory authorization for federal district courts to order disgorgement in SEC enforcement actions. Nevertheless, in 1971, the Second Circuit authorized disgorgement in *SEC v. Texas Gulf Sulphur Co*., 446 F.2d 1301 (2d Cir. 1971), based on the SEC's authority to seek civil penalties and "equitable relief." 15 U.S.C. § 78u(d)(5). Federal courts have uniformly adopted this view and permitted the SEC to seek equitable relief in the form of disgorgement over the past half-century. In contrast, the SEC is statutorily authorized to seek disgorgement in cases brought in administrative proceedings rather than federal court.

SEC enforcement actions seeking "any civil fine, penalty, or forfeiture" are subject to a five-year statute of limitations. 28 U.S.C. § 2462. Three years ago, in a 9–0 decision, the Court held in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), that disgorgement is a "penalty" or "forfeiture" rather than a remedial tool under 28 U.S.C. § 2462, for purposes of the applicable statute of limitations. The *Kokesh* Court expressly declined to address whether the SEC is entitled to seek disgorgement in federal courts in the first instance through its authority to seek "equitable relief" under Section 78u(d)(5), as equitable relief historically does not include penalties.[1]

Background on *Liu* Decision

Petitioners Charles Liu and Xin Wang solicited nearly $27 million from foreign nationals to invest in the construction of a cancer-treatment center. The SEC alleged that the petitioners misappropriated millions of dollars in funds raised from investors, in violation of the terms of the investment offering. The SEC brought a civil action against the petitioners, seeking disgorgement equal to the full amount petitioners had raised from investors (minus funds remaining in the petitioners' accounts), among other forms of relief. The petitioners argued that by seeking disgorgement for the total amount of monies raised, the disgorgement remedy failed to account for their legitimate business expenses. The district court disagreed and ordered the petitioners jointly and severally liable for the full amount. Petitioners appealed to the Ninth Circuit following the *Kokesh* decision, adding to their argument that the SEC lacked authority to seek disgorgement. The Ninth Circuit affirmed the lower court's decision, finding that the SEC was entitled to seek relief in the form of disgorgement and that the district court correctly rejected the petitioners' argument that disgorgement should be reduced by "legitimate business expenses."

[1] *Kokesh,* 137 S. Ct. at 1642 n.3.

Supreme Court Decision

The Court's decision to hear the *Liu* case was a surprise to many, and the decision has been the subject of speculation since certiorari was granted. Although many speculated the case may signal the end of SEC disgorgement, several justices indicated during oral arguments a willingness to limit *Kokesh* to the statute it addressed and permit disgorgement with certain limitations. In the opinion, the Court noted that it had granted certiorari in order to determine whether Section 78u(d)(5) authorizes the SEC to seek disgorgement beyond a defendant's net profits from wrongdoing; the Court ultimately determined that such authority is not within the scope of the SEC's enforcement powers.

In upholding the SEC's right to seek relief in the form of disgorgement, the Court relied upon the long-standing equitable principle of depriving wrongdoers of their ill-gotten gains. The Court reasoned that by limiting the amount of disgorgement to an individual wrongdoer's net profits, the remedy does not become a punitive sanction. The Court agreed with petitioners that legitimate business expenses must be deducted before awarding disgorgement under Section 78u(d)(5)—unless the entire profit of a business or undertaking results from wrongdoing—an evaluation that must be undertaken by the lower court. The Court also left it to the Ninth Circuit to determine on remand whether the petitioners can be found jointly liable for the ill-gotten gains they accrued as partners engaged in concerted wrongdoing, or whether individual liability is required.

The Court further clarified that disgorged funds must be for the benefit of the harmed investors and consistent with equitable principles. The Court noted that the SEC does not always return the entirety of disgorged proceeds to investors, and may instead deposit a portion of collections in a fund in the U.S. Treasury. The Court found that merely depriving a wrongdoer of ill-gotten gains does not alone render disgorgement appropriate or necessary for the benefit of investors. Rather, the Court held that if the SEC does not intend to return the entirety of disgorged funds to investors, lower courts must evaluate whether the relief sought is truly "for the benefit of investors" as required by Section 78u(d)(5).

Implications for SEC Enforcement and Defense Bar

Prior to the *Liu* decision, some courts required that the SEC remove so-called "legitimate" expenses from the disgorgement amount, reducing the remedy to only what a defendant actually received as a result of his or her wrongdoing. Other courts were comfortable ordering a defendant to disgorge the total amount of proceeds received from wrongful conduct, regardless of whether the defendant personally received or benefited from them. Going forward, courts and the SEC will be required to undertake a close analysis of the proposed disgorgement amount to ensure that it does not exceed the total amount of a wrongdoer's net profits after deduction for legitimate business expenses, a process that may become costly and time-consuming in some instances.

In addition, the disgorgement award will now be required to be returned to investors in all cases, rather than returned to the U.S. Treasury. The *Liu* decision will require the SEC to consider whether it makes sense to seek disgorgement through the established fair fund process to return money to investors, or come up with other less costly ways to do so. It also may impact the SEC's willingness to seek relief in the form of disgorgement at all in some cases, particularly where it believes that such a return would be unfeasible, whether due to the resulting administrative costs or other practical reasons such as difficulty in identifying the specific harmed investors. As a result, the SEC may rely more heavily on civil monetary penalties when exercising its enforcement powers.

In November 2019, the U.S. House of Representatives passed H.R. 4344: Investor Protection and Capital Markets Fairness Act, which provides statutory authority for the SEC to seek disgorgement in federal district courts, as well as certain other injunctive relief. If approved by the U.S. Senate and signed into law, it may provide the SEC with additional flexibility and fewer limitations when seeking disgorgement in the future.

If you have questions about these mandates, please contact **Junaid A. Zubairi** at +1 (312) 609 7720, **Rachel T. Copenhaver** at +1 (312) 609 7514, **Michael J. Quinn** at +1 (424) 204 7734, **Brooke E. Conner** at +1 (312) 609 7529, or any other Vedder Price attorney with whom you have worked.

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