

Client Alert

Supreme Court Reformulates SEC “Disgorgement” as “Equitable Relief”

Liu v. Securities and Exchange Commission; No. 18-1501 Decided June 22, 2020

Introduction

Congress has authorized the SEC to enforce the securities laws against those committing fraud both in SEC enforcement actions and in SEC administrative proceedings. In SEC administrative proceedings, the agency can seek both (a) civil monetary penalties and (b) “accounting and disgorgement.” 15 U.S.C. §§ 77h-1(e) & 77h-1(g). No statutory language grants “disgorgement” authority for SEC enforcement actions. *Liu v. SEC*¹, discussed in this Alert, involved an SEC enforcement action.

In enforcement actions, the SEC is authorized to request and obtain statutory (1) limited civil monetary penalties and (2) “equitable relief that may be appropriate or necessary for the benefit of investors.” 15 U.S.C. § 78u(d)(5) & 78u(d)(3). Since 1971, even prior to receiving authority for penalties and equitable relief, the agency obtained from federal courts what would later be called “disgorgement.” That remedy often required a defendant to disgorge to the SEC all ill-gotten gains from a fraudulent scheme without deduction for legitimate business expenses, and the disgorged funds were for the most part deposited in U.S. Treasury accounts to support SEC and other government operations, with about 25% collected in 2019 sent to investors. While the courts of appeals were unanimous in granting such unlimited disgorgement awards, the practice was not challenged and was never therefore approved by the Supreme Court.

SCOTUS Reformulates Disgorgement

On June 22, 2020, the Court in *Liu* decided whether “courts possess authority to order disgorgement in SEC enforcement.” The Court held 8-to-1 that “a disgorgement award that does not exceed a wrongdoer’s net profit and is awarded for victims is equitable relief permissible under § 78u(d)(5).” It stipulated the criteria to render disgorgement equitable, vacated the \$27 million judgement affirmed by the Ninth Circuit, and remanded for

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consideration of a disgorgement award under its new criteria. Justice Thomas, in dissent, concluded that disgorgement was not an “equitable remedy” and would have reversed the judgment. In the past, as the Court had noted in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), SEC disgorgement awards had the hallmarks of a non-equitable punitive sanction: disgorgement was “imposed as a consequence of violating public law, it is assessed in part for punitive purpose, and in many cases, the award is not compensatory.”

Defendants in *Liu* used the federal EB-5 program to raise about \$27 million capital in China to build a cancer-therapy center in California. Granting summary judgment for the SEC, the district court found that substantially all of the capital raised had been misappropriated and not used to build the center, as the investors were promised. The district court entered final judgment awarding the SEC about \$27 million in disgorgement and an additional \$8 million in civil monetary penalties. The court denied defendants’ request to deduct from the gross capital raised legitimate business expenses (e.g., purchase of cancer-treatment equipment and acquisition of land to build the center and lease payments for such land).

Criteria for Disgorgement as Equitable Remedy

In *Liu*, the Court stipulates at least three criteria a disgorgement judgment must meet to conform to the “equitable remedy” standard. Relying on its “longstanding equitable principles,” which the Court found Congress had incorporated into section 78u(d)(5), the Court concludes:

- disgorgement must be limited by the “net profits” of the defendant from the fraud scheme,
- disgorged funds must generally be distributed to victims of the fraud, and
- joint-and-several liability of defendants is not appropriate for judgments of disgorgement. Each defendant is liable for disgorgement of the net profits received from his or her individual wrongdoing.

The Court ruled that the “SEC’s disgorgement remedy ... is in considerable tension with equity practices.”

Future Litigation Issues

The Court remanded *Liu* with precious little guidance on the limits imposed on SEC disgorgement by its equity precedents. The Court has left it to the lower courts to ensure that disgorgement awards are “so limited.” These courts will now have to grapple with these issues, among others.

- How should “net profits” be defined and determined? An income statement definition? A more restricted legal definition?
- What are “legitimate business expenses?” Do they include taxes? Putting aside reasonable salaries of officers and owners of the business, salaries of operating personnel? Outside professionals such as lawyers and accountants employed to advise regarding business operations? Marketing expenses?

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- How much of disgorged funds can be turned over to the Treasury and not distributed to victims and still have a disgorgement award be equitable? The Court rejects the SEC position that merely bringing an enforcement action and depriving a wrongdoer of ill-gotten profits is for the benefit of investors, as required by statute. It leaves for lower court consideration the issue of whether infeasibility of identifying and distributing funds to investors meets the SEC's obligation to benefit investors by returning funds to them.
- If a defendant settles with and compensates a victim, is the amount of that compensation a credit against the disgorgement award?
- If a defendant paid the full disgorgement judgment to the SEC, will that defendant get credited for that payment in any private action brought by the victims?

One important issue not presented in *Liu* (but raised in amicus briefing) is the extent to which the Court's standard will apply retroactively. Presumably, the ruling applies to all judgments not yet made final or on appeal. Whether the Court's decision is applicable to prior cases where disgorgements were granted "in considerable tension with equity practices" (i.e., in excess of "net profits" without distribution of the funds to defrauded investors) is an issue that awaits further litigation.

¹ Sills Cummis & Gross P.C. was counsel to Mr. Charles Liu and his wife, Ms. Xin Wang, in the district court and court of appeals, and was co-counsel with Kellogg, Hansen, Todd, Figel and Frederick, P.L.L.C. in the Supreme Court.

Sills Cummis & Gross lawyers are available to assist in addressing any questions you may have regarding developments in SEC disgorgement, including any possible remedies available for prior disgorgement payments to the SEC that do not comply with the equitable criteria stipulated by the Court in *Liu*.

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