

Remedies in SEC Enforcement Actions: The End of Disgorgement?

The Supreme Court granted certiorari in a case that may well have a very significant impact on the remedies available in Commission enforcement actions: *Liu v. Securities and Exchange Commission*, No. 18-1501 (Cert. granted Nov. 1, 2019). The question the Court agreed to resolve is: “Whether the Securities and Exchange Commission may seek and obtain disgorgement from a court as ‘equitable relief’ for a securities law violation even though this Court has determined that such disgorgement is a penalty.” The case will be heard later this term.

Background

The Commission’s complaint centers on an EB-5 project. Petitioners (defendants below) Charles C. Liu and Xin Wang, operated a regional center. The program offers a path to citizenship for foreign nationals who invest either \$500,000 or \$1 million, depending on the location, in U.S. projects that create specified numbers of U.S. jobs.

The investment funds in this case were pooled and supposedly would be utilized to build a cancer treatment center. Construction began in 2015 but latter stalled. The Commission filed suit in the Central District of California alleging violations of Securities Act Section 17(a) and Exchange Act Section 10(b) centered on the use of the investor funds.

The District Court granted summary judgment in favor of the Commission, concluding there were violations of Securities Act Section 17(a)(2). The Court entered a permanent injunction as to each Defendant. The Court also imposed a fine of \$6,714,580 and ordered the payment of disgorgement of \$26,440,304 along with prejudgment interest. The Court refused to reduce that amount by the cost of construction. No fair fund was requested by the SEC. The Ninth Circuit Court of Appeals affirmed.

Reasons for granting the writ

Petitioners offered three key reasons for granting the writ. First, Congress did not

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authorize what the Petition calls “disgorgement penalties.” When the federal securities laws were enacted, and in subsequent amendments, Congress did not specifically authorize the SEC to seek disgorgement. To the contrary the Commission, in civil cases, was authorized to seek civil monetary penalties, injunctions and “appropriate or necessary” equitable relief (internal cites omitted). “Disgorgement does not fall within any of those categories,” the Petition notes, citing *Kokesh v. SEC*, 137 S.Ct. 1632 (2017).

Second, it is clear that the SEC remedy of disgorgement is not supported by “any express or implied authority of the federal courts to grant equitable relief.” At oral argument in *Kokesh* five Justices “noted the lack of any clear statutory authority for disgorgement” – Justices Kennedy, Sotomayor, Alito, Gorsuch and the Chief Justice. That lack of statutory authority makes it clear that Congress “cabined” the SEC’s authority to obtain monetary penalties only – disgorgement was not authorized. Third, disgorgement as an equitable remedy can be awarded to “restore the status quo after a wrong-doing, not punish, Petitioners argued. In contrast, punishment is the aim of disgorgement in cases such as this one. In Commission cases such as this, disgorgement “does not simply restore the status quo, it leaves the defendant worse off.”

This is precisely the situation here. Petitioners were directed to pay what is called disgorgement of over \$26 million. Yet it is clear that a substantial portion of the money raised was expended on the construction. In the end Petitioners will be nearly \$16 million in debt, a financial position that is far worse than what it was prior to the project.

Finally, *Kokesh* concluded that disgorgement in Commission cases is a penalty - the funds frequently are not returned to the investors. Under such circumstances the award is not designed to return the situation to the status quo. To the contrary, it is imposed because of a violation of public laws. Viewed in that context, the award is ordered to “vindicate the public interest.” Thus, the SEC has sought and obtained millions of dollars in disgorgement not as an equitable remedy but a penalty without statutory authority.

Respondents

Petitioners obtained about \$27 million from investors, much of which went to Petitioners, the Commission noted. The lower courts were thus correct in awarding disgorgement here. The decisions of those courts should stand – there is no reason to grant the writ.

First, judicial authority to award disgorgement derives from two sources. One is the statutory authority to “enjoin” violations which includes the power to “order a violator to disgorge profits . . .” (internal citations omitted). That authority is fortified by the Sarbanes-Oxley Act of 2002. There Congress amended Exchange Act Section 21(d) to authorize Courts hearing an enforcement action to order “any equitable relief that may be appropriate or necessary for the benefit of investors. This legislation was passed against an unbroken record of circuit courts permitting the award of disgorgement in Commission enforcement actions, the agency argued, citing cases such as *SEC v Texas Gulf Sulphur Co.*, 446 F. 2d 1301 (2nd Cir. 1971). This interpretation has been repeatedly confirmed by Congress which has over the years passed legislation that cited and/or referenced

disgorgement in Commission enforcement actions.

Second, while Petitioners rely on *Kokesh* to support their claim that disgorgement in SEC enforcement actions is inconsistent with equitable principles, their reliance is misplaced. There the Court concluded that disgorgement in enforcement actions is a penalty in the context of considering a question regarding the statute of limitations. While a remedy might be a penalty in one context, that is not determinative of other situations. That is the situation here.

Third, five decades of circuit court cases support the proposition that disgorgement in SEC enforcement actions is an equitable remedy. Indeed, since the decision of the Second Circuit in *Texas Gulf* the circuit courts have uniformly recognized that district courts can award disgorgement in Commission enforcement actions. That understanding has continued since *Kokesh*.

Finally, while Petitioners argue that the disgorgement award here is a penalty because the lower court failed to offset certain expenses, they are incorrect. Here the court concluded that the disgorgement awarded represented a “reasonable approximation of the profits causally connected to . . .” the violation.

Comment

Liu presents a significant issue for the SEC and its enforcement program. As the Commission points out in its papers, there is a virtually unbroken line of cases tracing back to at least *Texas Gulf* awarding the agency disgorgement. Congress has also repeatedly legislated against the backdrop of those cases, thus implicitly affirming the action of the courts.

Nevertheless, it is difficult to contend that disgorgement, as that term is used today by the SEC, is the traditional equitable remedy of years past. When the SEC requested an award of disgorgement in cases like *Texas Gulf* the argument was predicated on the traditional equitable power and authority of the federal courts. That remedy focused on restoring the status quo.

SEC disgorgement today seems to have moved far from its traditional roots. The impact of that shift may well have resulted in the passages cited from *Kokesh* about penalties by Petitioners. While the Commission is correct that the ruling in that case was tied to the dictates of Section 2467, it is also true that the awards sought in its enforcement actions are at least in part penalties.

Ultimately, the resolution of *Liu* may turn on the lack of statutory authority in the Securities Act and the Exchange Act. Each statute specifies the remedies available. Neither statute specifically authorizes disgorgement. For a Supreme Court which likes to focus on the plain language of the statutory text, those omissions may prove determinative despite years of circuit court decisions to the contrary.

