

SEC Disgorgement: Who Gets the Money?

Liu v. SEC, No. 18-15-1, argued before the Court last week, is potentially one of the most important cases to be heard by the Supreme Court on SEC Enforcement. The question under consideration is whether the Securities and Exchange Commission can request a federal court to award what the agency calls disgorgement – essentially the gross amount of money obtained through wrongful conduct.

Petitioners, Charles Liu and his wife, claim that the SEC version of disgorgement is not authorized by the federal securities laws. The SEC claims that its long-used remedy is not just essential to its Congressionally assigned task of protecting investors and markets but has been authorized by statute and a long line of cases. While the Court did not dispute the right of the agency to seek disgorgement during oral argument, the Justices seemed to have a very different notion of what constitutes that form of equitable relief from that of the SEC.

Background

Liu is based on an EB-5 offering. Approximately \$27 million was raised from investors for a construction program. The investors were Chinese citizens recruited for the program based on the promise of U.S. citizenship in return for an investment that will create a specified number of jobs in this country. Portions of the investor funds were used for the construction. Other portions were mishandled and/or misappropriated, according to the SEC. Suit was filed, followed by the entry of a freeze order and the appointment of a receiver.

In resolving the case the SEC demanded in disgorgement in the amount of \$27 million. Defendants claimed any disgorgement should be limited to the amounts they received – about \$6.7 million by Charles and \$1.5 million by his wife, Xin Wang.

The district court entered an order in favor of the Commission, awarding disgorgement in the amount of \$27 million. In making the award the court rejected defense claims that any disgorgement should be limited to the amounts received less business expenses.

Related Capabilities

- Securities & Financial Services Litigation & Enforcement

The Ninth Circuit Court of Appeals, applying existing precedent, affirmed.

Briefing before the Supreme Court

Petitioner: Petitioners contend that the SEC has no authority to seek an award of disgorgement in a federal district court action. In the federal securities laws Congress created a “comprehensive scheme for enforcement . . . the authority to seek extensive relief in federal court, including through defined tiers of civil monetary penalties . . .” That scheme does not include any specific authority to request or obtain disgorgement in federal court actions. While Congress did give the SEC the power to seek an “accounting and disgorgement” in administrative proceedings in the Remedies Act of 1990, and the CFTC the authority to seek “disgorgement” in “any action” in the Dodd-Frank Act of 2010, such authority was not conferred on the SEC. Under these circumstances, the Court has long recognized a presumption that Congress acted intentionally in omitting language authorizing the agency to seek such a remedy.

The SEC’s contention that the federal courts have the authority to order disgorgement under their equitable powers is also contrary to the Court’s decision in *Kokesh v. SEC*. There the Court carefully analyzed the concept of disgorgement as used by the SEC and concluded that it is a penalty. It is black letter law that where, as here, the remedy goes far beyond the profits obtained by the wrong doer, it is a penalty. This is particularly true when the funds are not returned to those harmed but rather are given to the U.S. Treasury as is often the case in SEC enforcement actions. The simple fact is that penalties such as the SEC disgorgement remedy cannot be awarded in equity.

While the *Kokesh* penalty conclusion was fashioned in the context of construing a federal statute of limitations, its rationale and reasoning are directly applicable here. That is particularly true here since the remedy is used in a punitive fashion, often seeking more than the claimed wrong doer obtained as in this case.

Likewise, SEC disgorgement cannot be viewed as an “accounting,” another traditional equitable remedy. This is because such relief is predicated on a breach of a fiduciary relationship that runs between the parties. That is not the case here.

Finally, the SEC’s claim that the remedy was implicitly authorized by Congress in a series of court decisions preceding the addition of Exchange Act Section 21(d)(5) in the 2002 Sarbanes Oxley Act is simply incorrect. While that provision does authorize federal courts to award relief in the interest of investors, it does not permit the imposition of a punitive remedy such as the kind of “disgorgement” claim sought here. Nor is there any reason to believe that somehow Congress intended to codify prior court cases on SEC disgorgement which at times took disparate views on how the requested award should be fashioned.

Where, as here, there is a comprehensive statutory scheme there is no reason to fashion the kind of disgorgement remedy sought by the agency. The SEC has more than sufficient enforcement authority under the statutory scheme fashioned by Congress.

Respondent: The Commission argued that Congress has authorized the disgorgement remedy it has long employed. Three key points support this contention and delimit the scope of review required in this case. First, disgorgement is the remedy of requiring a “conscious wrongdoer to pay over the profits attributable to the underlying wrong, according to the restatement (Third) of Restitution. Prior to 2002 the statutes provided that the Commission could obtain an injunction, an equitable remedy. The courts repeatedly held that the Commission could recover disgorgement.

Second, in 2002 Congress added Section 21(d)(5) to the Exchange Act as part of Sarbanes-Oxley. That section states in part that a district court can award “any equitable relief that may be appropriate or necessary for the benefit of investors” in a case initiated by the Commission. The phrase “any equitable relief” in the section plainly includes disgorgement – there is no predicate for reaching the opposite conclusion. The history of equitable relief confirms this reading of the statute. It is a fundamental equitable principle that no person can profit from his or her own fraud. Disgorgement of those profits is thus a basic equitable remedy.

Third, the context of the statute – other statutes passed during the period -- confirms this reading of the provision. Those statutes are The Insider Trading Sanctions Act, The Remedies Act, the PSLRA and SOX. Each refers to the authority of the Commission to secure disgorgement. Essentially, those statutes, as well as Section 21(d)(5), confirm the long standing view of the courts, tracing to the 1960s and 1970s, that disgorgement is an equitable remedy designed to preclude the wrongdoer from profiting as a result of engaging in prohibited conduct. That remedy was available to the SEC under the statutes prior to Sarbanes-Oxley. Section 21(d)(5) and later the Dodd-Frank, which authorized disgorgement for SEC administrative proceedings as well as two other federal agencies, confirmed the point.

Petitioners’ fail to present any convincing response to the points raised above. Their claims, based on historical equity practice traced to the days of the split bench, fail to consider the current equity position of the courts and that of Congress in 2002 when drafting Section 21(d)(5).

Finally, *Kokesh* does not preclude the Commission from obtaining disgorgement. The fact that SEC disgorgement does not always go to the victim does not preclude the use of the remedy. The focus of SEC disgorgement is to deprive the wrongdoer of the profits of illegal conduct which is precisely what it does. In the end, the task here is to properly interpret that Section. On its face, and viewed in context, it authorizes the SEC to obtain disgorgement as defined today. Other issues regarding the mechanics of disgorgement need not be considered.

Reply: The SEC’s claim that Congress ratified the views of certain courts in SOX in 2002 misses the mark. The decisions cited diverge in their views and are not uniform. The fact is, equity has never recognized the view adopted by the SEC which takes a historical remedy and converts it to a penalty, something not recognized by equity. The notion that Dodd-Frank somehow ratified SEC disgorgement by providing for the use of the remedy in administrative actions and to other federal agencies is a supposition that has never

been addressed let alone passed by Congress. In the end, the SEC seeks to evade a ruling on the question of disgorgement because there is no historical precedent for its position.

Argument

Petitioners: Counsel for Petitioners began by claiming that there is no statutory authority for the disgorgement remedy used by the SEC. Three points are key: 1) There is no statutory text for the remedy; 2) the SEC has statutory penalties so it does not need the remedy; and 3) the SOX amendments do not support its position.

First, there is no statutory text for the remedy. Nowhere in the federal securities laws is there text specifically stating that the SEC can seek disgorgement in a civil injunctive action. Perhaps more importantly, to the extent the agency claims the remedy can be crafted from the district court's equitable jurisdiction, *Kokesh* made it clear that SEC disgorgement is in fact a penalty. While that decision was made in the context of deciding a question regarding the statute of limitations, the same analysis applies here. Indeed, the funds often do not go back to the investors but to the U.S. Treasury.

Early in the argument, Justice Alito asked a question which seemed to echo throughout the argument: Could an accounting be done, net profits determined and later give to the victims? When there was debate regarding the difficulty of applying the proposition began, Chief Justice Roberts stepped in noting essentially how hard can this be? Indeed, Justice Gorsuch noted that in class actions a procedure is routinely used to identify the victims and distribute the funds to them.

Petitioners, however, rejected the proposal of Justice Alito. That approach would essentially create a new regime to defend a remedy that has no statutory basis and is contrary to the traditional equitable principles cited by the statutes and the courts which have permitted the SEC to obtain disgorgement. Disgorgement as used by the SEC is a penalty as *Kokesh* held and thus not within the meaning of the language incorporated into the statutes. Despite this contention Justice Ginsburg repeatedly questions the application of *Kokesh* in this case.

Respondent: Counsel for the Commission focused on two key points. First, *Kokesh* was decided, as Justice Ginsburg noted, in a specific context. It does not apply here.

Second, the general rule applicable should be that the Commission can recover net profits. In those instances, the agency tries to return the funds to the investors. There are, however, instances in which that is not possible. For example, in FCPA cases the profits obtained from a contract secured by a bribe cannot be returned to an injured victim.

In returning the funds there should be deductions that would create a net profits kind of calculation. While the agency tries to follow this approach, it may not always be possible. Deductions should be permitted, but that does not include the costs of operating the fraud.

Discussion

The positions of the parties radically diverge – no disgorgement per the Petitioners and disgorgement of the funds a defendant obtains per the SEC. The Justices also seems to have a uniform view: Disgorgement is permitted– but what is it. During the argument there was little discussion or reference to the statutory text by the Justices. There was also no reference to legislative history of the sections involved or discussions about what Congress intended to create in terms of remedies for the SEC.

Rather, the oral argument seemed to be premised on the idea that the SEC can in fact recover disgorgement. The real question is, “What is disgorgement?” Yet Petitioners continued to focus much of their effort on the claim that the SEC is not entitled to disgorgement because it is not mentioned in the statutory text. Stated differently SEC disgorgement does not exist. The Court seemed unconvinced.

The SEC fared little better. The Commission spent a good deal of time trying to convince the Court that its remedy was not really as awful as it looked in *Kokesh* - another penalty where huge sums of money are demanded and frequently obtained for the U.S. Treasury before the statutory penalties get added on. Rather, the remedy precluded wrong doers from profiting from prohibited conduct. Again the Court seemed unconvinced.

Justice Alito appeared to strike the right cord for the other Justices early on by noting that disgorgement should be a net profits kind of remedy where the money is returned to the victims. While Petitioners pushed back on this, and the Commission claimed that is what it tries to do but cannot always, the Court may well have coalesced around the remark of Chief Justice Roberts stating essentially how hard can that be?

The Chief Justice is clearly right. In many cases the SEC states how much money the defendants raised or obtained in its complaint as well as what is left. Surely whatever reasonable, appropriate expenses were incurred can be estimated and deducted. While the issue can appear difficult in matters such as insider trading actions in fact it is not. There the corporate insider who breaches his or her duty to the company to obtain the trading profits; the company and its shareholders should receive the profits. If the trading is based on a misappropriation theory, then the profits can go to the owner of the information.

It is always hazardous to project the outcome of a Supreme Court action based on oral argument. In this case, however, the Court seemed to be searching for a practical way to extract the ill-gotten gains from the wrongdoer while fashioning a way to return the funds to those wronged. In *Liu* the question should be straight forward – the investors who contributed the money through the EB-5 program should be awarded the funds after appropriate deductions. The decision is due by June 30, 2020.