November 5, 2019

Supreme Court to Hear Case on Validity of SEC Disgorgement

Introduction

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In June 2017, the Supreme Court issued its landmark *Kokesh* decision, which unanimously held that the remedy of "disgorgement" – regularly imposed by the SEC in securities enforcement actions – operates as a "penalty," rendering claims for disgorgement subject to the five-year statute of limitations set forth in § 2462.[1] On Friday, November 1, 2019, the U.S. Supreme Court agreed to consider whether the SEC has the authority to seek disgorgement *at all* – a question that it raised, but explicitly declined to address in *Kokesh*.[2]

The remedy of disgorgement operates as a "form of 'restitution measured by the defendant's wrongful gain.'"[3] No statute expressly authorizes the SEC to obtain the remedy of disgorgement in enforcement matters. Instead, as the Court explained in *Kokesh*, the SEC persuaded federal courts to order defendants to pay disgorgement beginning in the 1970s, at a time when the "only statutory remedy available to the SEC in an enforcement action was an injunction barring future violations of securities laws," and the Commission had no express authority to obtain any type of monetary relief.[4] At the time of this development, disgorgement was viewed as an exercise of the federal courts' "inherent power to grant relief ancillary to an injunction."[5]

After Congress expressly granted the SEC the ability to obtain civil monetary penalties in 1990, the SEC has continued to rely on disgorgement as a significant part of its arsenal to deter violations of the securities laws. The *Kokesh* decision reduced the potency of the remedy to some degree by limiting its application to monetary amounts obtained by a defendant within five years of the SEC's claim being filed. But even so, in 2018 alone, the SEC obtained orders imposing $2.51 billion of disgorgement, in comparison to $1.44 billion in civil monetary penalties.[6]

The question of whether or not the SEC has authority to seek disgorgement in the first place has wide-ranging implications not only for the SEC, but also for other regulatory agencies that routinely seek disgorgement such as the CFTC, FTC, FDA, and CFPB, among others.

The Supreme Court's Landmark *Kokesh* Decision & Footnote 3

In June 2017, the Supreme Court addressed the issue of whether the five-year statute of limitations set forth in § 2462, which applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise," also applies when the SEC seeks disgorgement.[7] Prior to that the point, the SEC had routinely taken the position that as part of its inherent equitable enforcement powers, disgorgement was not subject to the five-year statute of limitations applicable to civil penalties. The Court disagreed and unanimously held that SEC disgorgement operates as a "penalty" and therefore that any disgorgement claims must be commenced within five years.

The Court reasoned that disgorgement in an SEC enforcement matter is a penalty because courts impose disgorgement for violations of public laws, *i.e.* a wrong to the public, not an individual, and for punitive purposes, such as general

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[1] *Kokesh v. S.E.C.*, 137 S. Ct. 1635 (2017).
[2] *Id.* at 1642, n.3.
[3] *Id.* at 1640 (internal citation omitted).
[4] *Id.*
[5] *Id.* (internal citation omitted).
[6] 2018 Division of Enforcement Annual Report, p. 11. As of November 2018, the SEC estimated that *Kokesh* could result in up to $900 million in foregone disgorgement for matters already filed at that time. *Id.* at p. 5.
[7] *Kokesh*, 137 S. Ct. at 1640-41.

deterrence, rather than remedial measures. Additionally, the Court determined that disgorgement is not necessarily compensatory, since disgorgement is often paid to the U.S. Treasury instead of victims, and because disgorgement sometimes leaves defendants "worse off" – rather than simply restore the status quo – when, for example, disgorgement exceeds the amount of illegal profits received by an individual wrongdoer in an insider trading scheme.[8]

In reaching its decision, the Court explicitly declined to address whether or not courts have authority to issue SEC disgorgement, and expressly broadcasted this open question in the opinion's frequently cited "Footnote 3":

> Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to § 2462's limitations period.[9]

During oral argument, five different justices asked questions or made comments alluding to the absence of statutory authority.[10] While many defendants took up the Court's apparent invitation to challenge the SEC's disgorgement power, to date, no courts have allowed defendants to avoid paying disgorgement all together based on *Kokesh*.[11] Instead, the vast majority of courts have cited to Footnote 3 in rejecting defendants' challenges to the SEC's disgorgement power, reasoning that, since the Court did not rule on the issue, *Kokesh* does not directly conflict with existing precedent permitting courts to order SEC disgorgement as a form of equitable relief.[12]

The *Liu* Petition: The Supreme Court Agrees to Address Footnote 3

On Friday, the Court agreed to answer the question it left open in Footnote 3.[13] The petitioners, Charles Liu and his wife Xin "Lisa" Wang (together "Petitioners"), asked the Court to take up their case after the Ninth Circuit affirmed the lower court's disgorgement order of roughly $26.7 million.

SEC Complaint & District Court Decision

In May 2016, the SEC sued Petitioners in California federal court for allegedly defrauding immigrant investors who participated in an EB-5 Immigrant Investor Program in the hopes of securing green cards. According to the SEC, Petitioners raised roughly $26.7 million from immigrants that they claimed would be used to construct a cancer treatment center. Instead, Petitioners transferred roughly $8.2 million of investor funds to their own personal bank accounts and funneled $12.9 million to overseas marketers in violation of the terms of the offering documents.

In April 2017, the district court granted summary judgment in favor of the SEC, finding that Petitioners violated Section 17(a)(2) of the Securities Act of 1933. The district court granted all relief sought by the SEC: (i) disgorgement of $26.7 million, the total amount raised from investors, less the amount left over that could be returned; (ii) a civil monetary penalty of $8.2 million, the amount Petitioners unlawfully paid themselves; and (iii) a permanent injunction enjoining

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[8] *Id.* at 1644-45.

[9] *Id.* at 1642, n.3.

[10] Chief Justice Roberts and Justices Kennedy, Sotomayor, Alito, and Gorsuch all made comments or asked questions on this subject. Transcript of Oral Arg. Tr. 7-9, 13, 31, 52, *Kokesh v. SEC*, WL 2407471 (U.S. Apr. 18, 2017) (No. 16-529).

[11] *See e.g.*, Respondent's Opposition Brief, *Liu v. SEC*, No. 18-1501, p. 9 (Sept. 4, 2019) (hereinafter "SEC Opposition").

[12] For example, in just the past year, the Southern District of New York and District of Massachusetts both cited to Footnote 3 in rejecting challenges to the SEC's disgorgement authority. *See e.g.*, *SEC v. Rio Tinto PLC*, 2019 WL 1244933 (S.D.N.Y. Mar. 18, 2019); *SEC v. Berkey*, 2019 WL 1716703 (S.D.N.Y. Apr. 18, 2019); *Jalbert v. SEC*, 327 F. Supp. 3d 287 (D. Mass. 2018) (dismissing a class action brought by bankruptcy trustee seeking to force the SEC to return disgorgement because *Kokesh* "specifically noted" that it did not "change[] disgorgement law as to civil enforcement proceedings").

[13] Docket, *Liu v. SEC*, No. 18-1501 (last visited Nov. 4, 2018).

Petitioners from the future solicitation of EB-5 Program investors.[14] The district court did not deduct amounts characterized by Petitioners as legitimate business expenses, and ordered Petitioners to pay disgorgement to the SEC, but did not require that the SEC disburse funds to alleged victims.

Ninth Circuit Decision

Petitioners appealed to the Ninth Circuit, arguing, among other issues, that, in light of *Kokesh*, the district court lacked the statutory authority to order SEC disgorgement because SEC disgorgement was not an equitable remedy. Petitioners also argued that the district court erroneously calculated the disgorgement amount by failing to offset legitimate business expenses. The Ninth Circuit rejected Petitioners' argument, finding that "*Kokesh* expressly refused to reach this issue, so that case is not 'clearly irreconcilable' with our longstanding precedent on this subject."[15] It also held that the disgorgement amount was proper because it would be unjust to permit the defendants to offset expenses they used in the running the business to defraud investors.

Supreme Court Briefing in *Liu v. SEC*

Petition for Certiorari

On May 31, 2019, Petitioners filed a petition for certiorari, asking the Court to address "[w]hether 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." Petitioners argued that lower courts' existing precedent awarding disgorgement premised on its inherent power to grant equitable relief was untenable in light of *Kokesh*, and urged the Court to provide much needed guidance. Specifically, Petitioners argued that Congress explicitly authorized the SEC to seek injunctive relief, equitable relief, and civil monetary penalties in enforcement proceedings, but did not explicitly or implicitly authorize disgorgement penalties, which do not qualify as "equitable relief" under *Kokesh*.

Petitioners analogized their disgorgement order to the one issued in *Kokesh*: (1) they were made "worse off" and essentially penalized twice – once, for the $26.7 million in disgorgement, with no deduction for the $16 million characterized as legitimate business expenses, and, again, for the $8.2 million civil monetary penalty for the compensation they paid themselves; and (2) the disgorgement order did not require that the funds be disbursed to the alleged victims, meaning that the funds could wind up with the SEC or the U.S. Treasury – the hallmark of a non-compensatory sanction.

SEC's Opposition Brief

The SEC filed an opposition brief, framing the question presented as whether a district court has authority to order disgorgement of money acquired through fraud. The SEC argued that post-*Kokesh* disgorgement orders did not conflict with existing circuit court precedent because *Kokesh* held that disgorgement is only a penalty for purposes of the statute of limitations (not necessarily for purposes of its remedial authority), and recognized that a remedy may qualify as equitable relief, even if is considered penal for some purposes.

The Implications of *Liu* & Potential Legislative Intervention

The outcome in *Liu* could seriously undercut the SEC's enforcement power by taking away one of its most powerful tools, and by encouraging defendants to continue to challenge the SEC's remedial authority in other contexts, such as suspensions and bars. Additionally, *Liu* could call into question the power of other regulatory agencies to seek disgorgement.

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[14] *SEC v. Liu*, 754 F. App'x 505, 507 (9th Cir. 2018), *cert. granted sub nom. Liu v. SEC*, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).

[15] *Id.* at 509 (internal citations omitted).

Against this backdrop – and conspicuously absent in both Petitioners' and the SEC's briefing – is the fact that legislation is pending in both the House and Senate that could effectively overturn *Kokesh*. Of particular importance, the House Financial Services Committee recently overwhelmingly approved bipartisan legislation (H.R. 4344) that would codify the SEC's ability to seek – and courts to grant – disgorgement and extend the statute of limitations on disgorgement claims to fourteen years.[16] While the bill, known as the "*Kokesh*-fix," suggests that Congress had not previously authorized the SEC to seek disgorgement in enforcement proceedings (ironically, a helpful fact for Petitioners), if passed, it could have the effect of overturning *Kokesh* and mooting *Liu*. The full House has not yet set a date to consider and vote on the bill, a delay in part caused by opposition from advocacy groups, such as Americans for Tax Reform. In March 2019, a similar bill to codify SEC disgorgement was introduced in the Senate.[17] Unlike the House bill, the Senate bill would subject disgorgement claims to a five-year statute of limitations, but it would also codify a new cause of action for restitution with an expansive ten-year statute of limitations. The Senate Banking Committee has not yet considered the bill, though the Committee could turn to it before the end of the year.

The Supreme Court will likely hear argument in the case early next year, with a decision to follow by summer.

[16] H.R. 4344, *To amend the Securities Exchange Act of 1934 to allow the Securities and Exchange Commission to seek and Federal courts to grant disgorgement of unjust enrichment, and for other purposes*.

[17] Sens. Mark R. Warner and John Kennedy initially introduced Senate bill 799 on March 14, 2019, but added a revised version of their proposal as a new title in a separate bill, known as the ILLICIT CASH Act, on September 26, 2019. *See* S. 2563, *ILLICIT CASH Act*.