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Disgorgement: A Longstanding SEC Weapon, Now Under Attack

by Michael J. Gorback

On November 1, 2019, the Supreme Court granted certiorari in *Liu v. Securities Exchange Commission*, No. 18-1501. The Court will decide whether the Securities Exchange Commission (SEC) may seek and obtain disgorgement from a defendant as equitable relief for a securities law violation. The outcome will have widespread implications for corporate and securities lawyers.

Background

Defendant Charles Liu formed and controlled three corporate entities to build and operate a proton therapy cancer treatment center in Southern California. Liu financed the center with nearly $27 million dollars of international investments through the EB-5 Immigrant Investor Program. Instead of pursuing therapy, Liu funneled over $20 million to himself, his wife, and marketing companies associated with them.

The SEC sought summary judgment against Liu and his wife in the United States District Court for the Central District of California for allegedly violating securities laws. The district court granted the SEC's motion and ordered the defendants to disgorge the profits, which amounted to $27 million, in addition to paying over $8 million in civil penalties and other remedies.[1]

On appeal before the Ninth Circuit, Liu challenged the district court's disgorgement order. Citing *Kokesh v. Securities Exchange Commission*[2], Liu argued that district courts lack the authority to order disgorgement in SEC enforcement proceedings, as disgorgement is not a form of equitable relief and Congress never authorized it.[3] However, the Ninth Circuit disagreed and affirmed the district court's order, reasoning that it was bound by pre-*Kokesh* circuit precedent.

Subsequently, Liu filed a petition for a writ of certiorari with the United States Supreme Court to review the broader question of whether the SEC has the authority to pursue disgorgement in civil enforcement proceedings.

The Underlying Case — *Kokesh v. SEC*

In June 2017, the Supreme Court held in *Kokesh v. Securities Exchange Commission*[4] that disgorgement in SEC enforcement

proceedings operated as a “penalty” for statute-of-limitations purposes. Forming the basis of its decision, the Court reasoned that penalties (i) seek to redress crimes against the public, as opposed to against individuals, and (ii) operate for the purposes of punishment and deterrence rather than compensation.[5] The SEC disgorgement orders met this standard because they “go beyond compensation, are intended to punish, and label defendants wrongdoers as a consequence of violating public laws.”[6] However, the decision offered no guidance to lower courts as to whether the classification of disgorgement as a “penalty” was limited to the specific statute, or whether disgorgement in general is considered to be a penalty, not an equitable remedy. This ambiguity has caused confusion over the holding's reach.

In what now appears as foreshadowing, one footnote of the decision reads, “[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings.”[7] The SEC applied that footnote in its opposition brief[8] currently before the Supreme Court to strengthen its argument that disgorgement continue to be available as an equitable remedy. The SEC also argued that the Court’s narrow holding was intentional—that *Kokesh* only classified disgorgement as a penalty “within the meaning of [28 U.S.C.] 2462,” a five-year statute of limitations for actions to enforce civil penalties, and purposefully declined to consider whether the SEC was authorized to seek disgorgement as an equitable remedy.

Why Does It Matter?

For decades, it has been common practice for the SEC to seek and obtain a disgorgement order as a form of equitable relief to defrauded investors. However, by addressing the issue, the Supreme Court signals vulnerability for the SEC's long-recognized authority in this area. The *Kokesh* decision highlights the discord between disgorgement and equitable remedies. Most notably, the Court opined that disgorgement operates as a penalty when the “primary purpose of disgorgement orders is to deter violations of securities laws.”[9] In *Liu*, the Court will have the opportunity to reconcile the difference.

American Jurisprudence defines disgorgement as “a punitive equitable remedy designed to deter violations of the securities laws by depriving violators of their ill-gotten gains. Disgorgement takes into account the fact that the issuance of an injunction, by itself, does not correct the consequences of past activities. This remedy may also be imposed if the court believes that a defendant should not profit from his or her wrong, but equitable considerations indicate that an injunction should not be granted.”[10] Under this reading, the remedy exists both to deter future wrongdoing and to cure the harm to victims.

Conclusion

It should come as no surprise if the Supreme Court decides to disrupt the course of dealing between the SEC and the federal judiciary, and reign in administrative power. A decision in favor of Liu will have sweeping implications on a wide range of stakeholders including the SEC and the FTC, lower courts, and companies that operate under securities regulations and federal securities laws. It may also generate a wave of lawsuits challenging former disgorgement orders.

The Supreme Court's composition is much different now than it was when it presided over *Kokesh* two years ago. As written by then-Judge Kavanaugh in a D.C. Circuit concurring opinion, “the Supreme Court's decision in *Kokesh* overturned a line of cases from [the D.C. Circuit] that had concluded that disgorgement was remedial and not punitive” and that *Kokesh* was “not limited to the specific statute at issue there.”[11]

As we await the outcome of this case, we may see fewer SEC enforcement actions in federal court. We may also expect the SEC to advance legislation that would codify its authority to seek disgorgement.

Congress already has one such bill sitting before it.[12]

[1] *SEC v. Liu*, 262 F.Supp.3d 957, 976 (C.D. Cal. 2017).

[2] *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

[3] *SEC v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018), *cert. granted*, 2019 U.S. LEXIS 6599 (2019) (No. 18-1501).

[4] *Kokesh v. SEC*, 137 S. Ct. 1635, 1643 (2017).

[5] *Id.* at 1642.

[6] *Id.* at 1645.

[7] *Id.* at 1642 n.3.

[8] Brief for the Respondent in Opposition at 7, *Liu v. SEC*, 2019 U.S. LEXIS 6599 (2019) (No. 18-1501).

[9] *Kokesh v. SEC*, 137 S. Ct. at 1643.

[10] 69A Am. Jur. 2d *Securities Regulation—Federal* § 1519 (footnotes omitted).

[11] *Saad v. SEC*, 873 F.3d 297, 305 (D.C. Cir. 2017).

[12] Securities Fraud Enforcement and Investor Compensation Act of 2019, S.799, 116th Cong. (2019).

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