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JUNE 25, 2020

Liu v. SEC: Supreme Court Rules on SEC's Right to Seek Disgorgement

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On June 22, 2020, the U.S. Supreme Court ruled in *Liu v. SEC* that the SEC can continue to seek disgorgement in federal court actions in response to violations of the securities laws. While the Supreme Court agreed with the SEC that disgorgement was an available remedy, the Court limited the scope of such awards to the defendant's net profits from the alleged fraud and explained that disgorgement is only proper to the extent that it directly benefits harmed investors. The Supreme Court expressed skepticism over the SEC's ability to continue its practice of transferring disgorged funds to the U.S. Treasury instead of distributing those funds directly to harmed investors. The Supreme Court, however, refused to rule on that issue, leaving it to the lower courts to decide whether and under what circumstances disgorgement can still be awarded if the funds cannot be returned to investors.

The Conduct at Issue in *Liu* and Procedural History

Liu involved an enforcement action brought against a married couple, Charles Liu and Xin Wang, regarding an offering memorandum soliciting investments pursuant to the EB-5 Immigrant Investor Program.[1] Liu and Wang allegedly told prospective investors that their money would fund the construction and operation of a proton therapy cancer treatment center in Southern California. The couple successfully raised $27 million from investors.

The SEC brought a civil action against the couple in the District Court for the Central District of California, alleging that they violated the terms of the offering memorandum by misappropriating millions of dollars. The district court found in favor of the SEC and enjoined the couple from participating in the EB-5 Program, imposed civil penalties on them, and ordered them to disgorge the full amount they had raised from investors.

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1 The program offers U.S. permanent residency to foreigners in exchange for a qualifying minimum investment in a "targeted employment area." The program aims to create domestic jobs. While the minimum investment was $500,000 during the events underlying *Liu*, it is currently $900,000.

The couple contested the disgorgement award, arguing, among other issues, that it failed to account for sums spent on legitimate business expenses. Liu and Wang argued that these legitimate business expenses should be deducted from the sums they were required to pay. The district court rejected that argument, and the Ninth Circuit Court of Appeals affirmed.

The Supreme Court agreed to review the issue of whether "the SEC [can] seek disgorgement beyond a defendant's net profits from wrongdoing." The Supreme Court vacated the judgment in *Liu* and remanded the case for further proceedings consistent with its directives on the proper scope of disgorgement awards in federal court. Justice Sotomayor wrote the majority opinion. Justice Thomas was the lone dissenter.

The Supreme Court Caps Disgorgement at Net Profits from Wrongdoing and Emphasizes the Need to Return Money to Fraud Victims

The Securities Exchange Act of 1934 gives the SEC authority to initiate two kinds of actions in pursuit of corresponding remedies. The SEC can either: (1) seek limited civil penalties and disgorgement through administrative proceedings; or (2) seek civil penalties and "equitable relief" through civil actions filed in federal court. The statute does not define what qualifies as "equitable relief" in court proceedings.

The SEC routinely invokes its authority to seek equitable relief when it pursues disgorgement, and did so in *Liu*. Liu and Wang argued that the contemplated disgorgement had punitive traits, which meant in their opinion it could not qualify as equitable relief, and thus the SEC lacked the authority to seek that remedy. The couple cited an earlier Supreme Court case, *Kokesh v. SEC*, which classified disgorgement as a "penalty" for statute of limitations purposes. However, the *Kokesh* Court explicitly cautioned that its opinion did not address the separate question of "whether courts possess authority to order disgorgement in SEC enforcement proceedings."

When the Supreme Court first granted certiorari in *Liu*, it seemed likely that the Court would use the case as the vehicle to address the issue specifically reserved in *Kokesh* – namely, whether disgorgement qualifies as equitable relief that the SEC is allowed to pursue in federal court. Unlike most cases that make their way to the Supreme Court, there was no existing circuit split in *Liu*. Rather, there was general agreement among the circuits at the time the appeal was granted that disgorgement awards were permissible. Some commentators, therefore, assumed that the Supreme Court's desire to hear the appeal signaled that the Court was inclined to do away with disgorgement altogether. They reasoned there would be no need to grant certiorari to tell the lower courts their prior assessment of the issue was correct.

Oral argument held in early March of this year revealed that the Court was more interested in limiting disgorgement rather than doing away with it. Most of the questioning and commentary from the Court during argument focused on whether the Court should rule that disgorgement is limited to the net profits of the defendant and whether it should be a requirement that disgorged funds be returned to the injured investors. The Court's opinion issued this week focuses not surprisingly on those two issues.

The Court's opinion is clear that limiting disgorgement awards to the defendants' net profits must now occur or the award will not qualify as equitable relief authorized in federal court. The Court, however, refused to parse through what portion, if any, of the SEC's disgorgement request against Liu and Wang was attributable to legitimate expenses and therefore must be deducted and instead remanded that question for consideration by the court below. The Supreme Court explained that it would be preferable for the lower court to perform the analysis it had previously declined to address – namely, analyzing whether some of the money Liu and Wang spent related to legitimate business expenses.

Less clear from the majority opinion is whether the SEC will be entitled to disgorgement going forward if it is not feasible to return the money to investors. The Supreme Court emphasized that the statute authorizing the SEC to pursue equitable relief in federal court requires such relief to be "appropriate or necessary for the benefit of investors." The Court explained that a disgorgement award distributed directly to the harmed investors would qualify as being sufficiently beneficial to investors, but questioned whether an award not distributed to investors could ever be said to be "for the benefit of investors."

The Court referred specifically to the practice sometimes followed by the SEC of transferring disgorgement awards to the U.S. Treasury, after which those sums are used to pay whistleblowers who assist the SEC in investigating claims. The SEC has awarded over $500 million to whistleblowers since the inception of its whistleblower program and earlier this month awarded $50 million to one individual in the largest award to an individual in the program's history. It would be a blow to the SEC if it lost the ability to use disgorged funds to issue awards designed to create a financial incentive for whistleblowers to come forward.

The Supreme Court, however, declined to rule expressly on the issue of whether disgorgement is permissible when some or all of the award is not returned to investors. The Court made clear that a generalized benefit to "the public at large" would not suffice to meet the requirement of the award being for the benefit of investors. That would seem to foreclose an argument the SEC could have made that funding whistleblowers arguably "benefits" all investors because whistleblowers assist the SEC in detecting fraud.

Takeaway and Impact

Aside from preserving the SEC's use of disgorgement with new limits, *Liu* certainly increases the burden on the SEC in attempting to locate and return funds to investors. The Court's ruling in *Liu* suggests that the SEC does not have the discretion to opt out of returning funds if the investors at issue can be located. *Liu* suggests that this should always happen when feasible. The open question in *Liu* is whether the SEC will still be allowed to transfer funds to the U.S. Treasury if they can meet their burden to show that returning the funds directly to investors is not feasible.

In addition, the lower courts will likely look to *Liu* when deciding whether other federal agencies, such as the Federal Trade Commission (FTC), may seek disgorgement under similar statutory schemes. *Liu* does not answer the question of whether the FTC has the authority to obtain monetary equitable relief in federal court – that remains an open question with a split among the circuits and Supreme Court certiorari petitions pending on 2019 Seventh and Ninth Circuit decisions. However, *Liu* does seem to cut back on the amount that the agency could obtain for restitution or disgorgement. The FTC typically calculates this amount based on the total loss to consumers. But *Liu* would seem to limit the amount to defendants' profits minus legitimate business expenses. What constitutes a legitimate business expense will likely involve a fact-heavy inquiry, and *Liu* does not clearly address how this would work with a wholly fraudulent operation as compared to a legitimate company found to have violated the finer points of Section 5 of the FTC Act on unfair or deceptive acts or practices.

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