SUPREME COURT HEARS ORAL ARGUMENTS IN LIU V. SEC TO DETERMINE THE FATE OF THE SEC'S ABILITY TO SEEK DISGORGEMENT IN JUDICIAL PROCEEDINGS

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On March 3, 2020, the Supreme Court heard oral arguments in Liu v. SEC, once again taking up the question of whether the Securities and Exchange Commission ("SEC") may seek disgorgement as equitable relief for a securities law violation. Liu is the latest test of the viability of the SEC's historic ability to seek disgorgement in an enforcement proceeding and comes close on the heels of the Court's 2017 unanimous holding in *Kokesh v. SEC*. That holding found that SEC disgorgement constitutes a "penalty" in the context of an administrative proceeding and is thus subject to the standard limitations on penalties, including statute of limitations restrictions. [1] Historically, the SEC's practice has been to seek disgorgement going back to the start of the violation in many cases. [2] This led to disgorgement calculations sometimes going back years (or decades), which the Supreme Court curtailed in *Kokesh*. The question before the Court in Liu was whether disgorgement, permitted in an administrative proceeding by statute but now considered a "penalty" under *Kokesh* in a judicial proceeding, is available to the SEC at all under Section 21(d). Though we expect that the opinion of the Court will not issue for several months, a majority of the justices seemed amenable to the SEC's continued use of disgorgement as equitable relief subject to limitations on how disgorgement is calculated; and, whether defrauded individuals, the SEC, or the U.S. Treasury is entitled to disgorged funds. However, even if the SEC's disgorgement ability stands, any future limitations or restrictions imposed by the Court, such as the manner of calculating disgorgement or the parties who may receive equitably disgorged sums, will have widespread impact on the SEC's ability to continue its traditional enforcement regime absent corrective legislation from Congress.

Liu emerges from an SEC action filed in the Central District of California against spouses Charles Liu and Xin Wang for violations of the Securities Act of 1933 in connection with a scheme in which they raised $27 million from Chinese investors through the EB-5 Immigrant Investor Program to construct and operate a cancer treatment center. The couple failed to build the center, instead paying themselves $8.2 million in salary and a marketing firm $12.9 million to solicit new investors. [3] Granting summary judgment to the SEC, the district court imposed a permanent injunction against future solicitation of EB-5 program investors, civil penalties of $8.2 million, and disgorgement of all funds defendants had raised from investors. [4] On appeal, the Ninth Circuit rejected defendants' arguments that the recent *Kokesh* case barred the district court from ordering disgorgement in the amount prescribed. [5] The Ninth Circuit emphasized that *Kokesh* expressly declined to assess whether courts have authority to order disgorgement in SEC enforcement proceedings. [6] Liu and Wang petitioned the

Supreme Court for certiorari to settle the question, left unanswered in *Kokesh*, of whether the SEC has any ability to seek disgorgement as a remedy in a judicial proceeding. [7]

At oral arguments on March 3rd, the petitioners argued that: (1) the absence of express statutory authority granting the SEC the power to seek disgorgement in judicial proceedings limits the SEC to the remedy of authorized penalties in that context; (2) disgorgement is a penalty under *Kokesh*, a penalty is not a form of equitable relief, and therefore disgorgement is invalid under Section 21(d); and (3) the phrase "equitable relief" in Section 21(d) did not ratify circuit court cases that previously approved SEC disgorgement. [8] The SEC in turn argued that the Court's holding in Kokesh should be read narrowly to apply only for statute of limitations purposes rather than as a broad condemnation of the SEC's ability to seek disgorgement at all. The SEC further argued that, though it is a general rule that net profits are the measure used in calculating disgorgement, it is also consistent with traditional equitable principles to use more expansive measures to calculate appropriate disgorgement, as happened in the present case. Finally, the SEC asserted that general equitable principles — rather than a specific, court-mandated formula — should guide disgorgement calculations in future judicial proceedings. [9] In other words, the SEC argued for the status quo (post-*Kokesh*) while the petitioners are seeking radical limitations on the SEC's powers.

It is never easy to predict how the Court will rule based on oral arguments. However, the justices' questioning during oral argument provides some indication the Supreme Court may continue to permit the SEC to pursue disgorgement in judicial proceedings, but the SEC may place limits on how disgorgement is calculated and what parties should receive the proceeds of disgorgement. Justice Ginsburg appeared to reject petitioners' argument that disgorgement should be considered a penalty — and thus, the SEC's ability to seek it is limited by statute — in all judicial proceedings. [10] Justice Alito discussed limitations on disgorgement, asking whether disgorgement limited to net profits that would be returned to victims of the fraud would constitute a traditional form of equitable relief. [11] At present, a high percentage of disgorgement from defendants in SEC actions is paid to the U.S. Treasury rather than returned to victims or investors when those are identifiable. The Court devoted a substantial amount of its questioning on the ultimate destination of an equitable remedy: defrauded investors, the SEC, or the U.S. Treasury. When addressing counsel for the SEC, Justices Sotomayor, Kavanaugh, and Gorsuch probed the circumstances in which each potential recipient was entitled to receive such a remedy, directly asking counsel whether the government would take issue with a rule requiring disgorged funds to be returned to investors "where feasible." [12]

It remains to be seen how the Supreme Court will rule in *Liu*. However, oral argument focused on whether disgorgement should be limited rather than whether it should be authorized at all, suggesting the Court will not bar the SEC from seeking it outright in judicial proceedings. The Court appears unlikely to extend its holding in *Kokesh* that disgorgement constitutes a penalty in order to prevent the SEC from seeking disgorgement in judicial proceedings. Such a decision would immediately limit the SEC's ability to proceed in the traditional manner in enforcement cases, not to mention possibly re-opening past cases. Instead, it appears Liu may determine how, rather than if, the SEC can seek disgorgement when enforcing securities laws in federal court. In addition, the potential implications for such a ruling could greatly limit high-value disgorgement recoveries in cases involving a large, undefinable class of defrauded parties, such as Foreign Corrupt Practices Act cases. We will continue to monitor this matter and any future decisions that could impact our clients involved in SEC proceedings.

NOTES:

[1] *See Kokesh* v. SEC, 137 S. Ct. 1635 (2017).
[2] Section 21(d) of the Securities Exchange Act of 1934 enables the SEC to seek "any equitable relief that may be appropriate or necessary" in judicial proceedings and is the source of the SEC's ability to seek judicial relief in enforcement proceedings. Securities Exchange Act of 1934 § 21(d)(5), codified as 15 U.S.C. § 78u(d)(5).
[3] *See SEC v. Liu*, 262 F. Supp. 3d 957 (C.D. Cal. 2017), *aff'd,* 754 F. App'x 505 (9th Cir. 2018).
[4] *See Liu,* 754 F. App'x at 507, *cert. granted*, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).
[5] *See id.* at 509.
[6] *See id.* (citing Kokesh, 137 S. Ct. at 1642 n.3).
[7] *See* Pet. for a Writ of Cert. at 1–3, Liu v. SEC, No. 18-1501 (filed May 31, 2019).
[8] *See* Transcript of Oral Argument at 3–5, Liu v. SEC, No. 18-1501 (argued March 3, 2020).
[9] *See id.* at 29–34.
[10] *See id.* at 5–6.
[11] *See id.* at 8.
[12] *See generally id.*

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