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Supreme Court Holds That SEC's Power to Obtain Equitable Relief Includes Disgorgement of Wrongdoers' Net Profits but Leaves Important Questions Open Regarding Its Scope

by James J. Boland

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On June 21, 2020, the United States Supreme Court held that disgorgement of a wrongdoer's net profits in an SEC enforcement action qualifies as "equitable relief" authorized by the Securities and Exchange Act ("Act"), 15 U.S.C. § 78a, et seq. *Liu v. Securities and Exchange Comm'n*, No. 18-1501, 2020 WL 3405845, 591 U.S. --- (2020).

Under Section 78u of the Act, the SEC is authorized to, among other things, institute actions for violations of the Act and to obtain injunctive relief and monetary penalties. 15 U.S.C. § 78u(d)(1)-(3). In addition to these remedies, the Act provides that "[i]n any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." *Id.* In *Kokesh v. Securities and Exchange Comm'n,* 137 S.Ct. 1635 (2017), the Court held that disgorgement in the securities enforcement context is a penalty, subject to the applicable five year statute of limitations for enforcement of fines and penalties.

At issue in *Liu* was whether disgorgement also qualifies as "equitable relief" under the Act. In *Liu*, Charles Liu and his wife solicited $27 million from foreign investors under the EB-5 Immigrant Investor Program, which allows noncitizens to apply for permanent residence by investing in approved enterprises. The private offering memorandum disclosed that a small administrative fee would be used to fund expenses. In reality, only a fraction of the $27 million was invested in the enterprise at issue. Liu spent nearly $20 million on salaries and other expenses, and diverted a large amount of funds to personal accounts and those of a company he controlled.

The SEC brought a civil action against Liu and his wife. The district court found for the SEC, granting an injunction barring Liu and his wife from participating in the EB-5 program and imposing a large civil penalty. The court also ordered disgorgement of the full amount Liu raised from investors, without any allowance for costs and expenses, and ordered Liu and his wife jointly and severally liable for the award. The Ninth Circuit affirmed.

The Supreme Court vacated the judgment. In doing so, however, the Court agreed with the SEC and the courts below on the primary issue of whether any form of disgorgement could be ordered as equitable relief under the Act. Analogizing disgorgement to the categories of relief typically available in equity to the extent that it deprives wrongdoers of their ill-gotten gains, the Court held that disgorgement qualifies as equitable relief authorized by Section 78u(d)(5).

The Court also acknowledged other specific challenges to the disgorgement order at issue, all of which relate to the proper scope of a disgorgement award: (i) the award failed to return funds to investors; (ii) the award imposed joint and several liability on Liu and his wife; and (iii) the award failed to deduct business expenses. Although the Court declined to decide these questions on the basis that they were not fully briefed by the parties, the Court nevertheless offered guidance for the lower courts to consider on remand. The Court's guidance, however, and the dissent's response, leave a number of questions open as to the permissible scope of a disgorgement award under Section 78u(d)(5).

As for returning funds to investors, both the Court and dissent recognized that the statute restricts equitable relief to that "appropriate or necessary for the benefit of investors." The Court, however, declined to address whether that requires the SEC to distribute all funds collected to investors or allowed the SEC to retain funds (the dissent would require all funds returned). Instead, the Court left the determination of whether the award was nonetheless "for the benefit of investors" for the lower courts. On the question of joint and several liability, the Court and dissent both acknowledged that imposing such liability is inconsistent with the rule of individual liability for wrongful profits, which could transform an equitable remedy into a penalty. But the Court went on to report that because the common law recognizes joint liability for partners engaged in wrongdoing, the lower courts could determine whether equitable principles would permit imposition of joint liability in the case.

Finally, on the issue of deducting expenses, the Court and dissent agreed that, consistent with the Court's ruling on the primary issue, only the profits obtained by a wrongdoer could be disgorged from a wrongdoer as a matter of equity. The Court therefore recognized that "legitimate expenses" must be deducted from revenues before ordering disgorgement. The Court, however, opined that circumstances may exist such that some expenses might be fraudulent or otherwise illegitimate, and therefore may not be appropriate to deduct in an equitable profits-based remedy. The Court thus left the issue to be addressed by the lower courts.

Liu is significant, in that it specifically recognizes an additional basis for a monetary remedy recoverable by the SEC as equitable relief in enforcement actions, and one that may have been thought inconsistent with the Court's 2017 decision in *Kokesh* finding that disgorgement is a penalty. At the same time, Court declined to decide a number of questions necessary to determine the precise parameters of that remedy, which are critical to both the size and use of any award. Instead, these questions have been left for lower courts to address according to "equitable principles," and to do so in the context of the specific facts and circumstances of particular cases.

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Jim has extensive experience and has represented a variety of corporations, businesses and professional firms in matters involving reinsurance (life & health, property & casualty), antitrust, securities fraud, accountant liability, consumer protection, shareholder and derivative disputes, mergers and acquisitions disputes, including post-closing disputes, and a variety of other commercial matters. He also has extensive experience in class action litigation, representing corporations and businesses in matters involving antitrust, securities fraud, residential and commercial mortgage practices, commercial leasing and other retail sales and marketing practices, and has experience in SEC and other governmental investigations.

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