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Dismantling the SEC's Federal Court Disgorgement Authority

Will the Supreme Court finish what it started in 'Kokesh'?

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This term, the Supreme Court will consider whether a federal court can order disgorgement in an enforcement action brought by the Securities and Exchange Commission. *Liu v. SEC*, No. 18-1501. Under a disgorgement order, defendants are required to turn over gains derived from violating the federal securities laws.

In *Kokesh v. SEC*, 137 S.Ct. 1635 (2017), the court held that SEC disgorgement is a "penalty" subject to the securities laws' five-year statute of limitations for penalties. 5 U.S.C. §2462. Now, the court has agreed to hear an appeal from the Ninth Circuit presenting the question whether the SEC may seek disgorgement at all in federal court. See *SEC v. Liu*, 754 Fed. Appx. 505 (9th Cir. 2018), cert. granted Nov. 1, 2019.

Background

The SEC has for decades obtained disgorgement in enforcement proceedings brought in federal court. See *SEC v. Texas Gulf Sulphor Co.*, 446 F.2d 1301 (2d Cir. 1971). In view of §2462's five-year statute of limitations, which applies when the Commission seeks a "penalty" for securities law violations, *Kokesh* considered the propriety of a disgorgement judgment that encompassed funds tracing back far longer than five years. 5 U.S.C. §2462. The SEC argued that disgorgement is "remedial" and not "punitive," meaning that the five-year statute of limitations should not apply. *Kokesh*, 137 S.Ct. at 1644. The court disagreed, reasoning that a disgorgement order is a "penalty" because (1) it is ordered for violations against the United States, rather than aggrieved individuals; (2) it is imposed for punitive purposes—namely, deterrence; and (3) disgorged funds often go to the government, not the victims. Id. at 1643-44.

The SEC estimates that *Kokesh* has resulted in it losing approximately $1.1 billion in disgorgement. SEC Division of Enforcement 2019 Annual Report at 21. Yet, disgorgement continues to account for a

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substantial majority of the funds the SEC obtains in enforcement actions. For example, the SEC obtained more than $3.2 billion in disgorgement in fiscal year 2019, approximately $400 million more than in 2016, the year before *Kokesh*. This increase may be attributable in part to other offsetting factors, including large one-time penalties that boosted returns from enforcement. But it illustrates that *Kokesh* itself did not eviscerate the SEC's disgorgement remedy, though it may have laid the groundwork.

The defendant in *Kokesh* never disputed that federal courts have authority to order disgorgement in SEC enforcement actions. But during oral argument, several members of the court—including the Chief Justice—expressed skepticism that the SEC had authority to seek disgorgement in federal court. See, e.g., Oral Arg. Tr. 31-32. And in its decision, the court expressly reserved the larger question of the SEC's authority—all but inviting a challenge like the one the court has agreed to hear in *Liu*. *Kokesh*, 137 S.Ct. 1642 n.3.

The Present Challenge

The facts in *Liu* are fairly straightforward. Petitioners Charles Liu and Xin Wang raised nearly $27 million from foreign nationals interested in a U.S. program—the EB-5 Immigrant Investor Program—that grants visas to foreigners who invest in certain U.S. businesses. According to the government, petitioners promised that the money would fund the construction of a cancer-treatment center, but instead diverted the funds to their own personal bank accounts and elsewhere overseas.

As a result, the SEC brought an enforcement action in federal district court. After determining that Petitioners had violated the securities laws, the court ordered $26.7 million in disgorgement—its estimate of Liu and Wang's profits from the scheme. The Ninth Circuit affirmed, citing longstanding circuit precedent authorizing disgorgement. *Liu*, 754 Fed.Appx. at 509. Liu and Wang's petition to the Supreme Court followed.

The SEC's power to seek disgorgement as an equitable remedy in federal court appears increasingly tenuous, given the court's grant of certiorari without a circuit split, the express reservation in 'Kokesh', and the skepticism several Justices expressed during oral argument in that case.

Typically, the Supreme Court agrees to hear a case to resolve a disagreement among the federal circuit courts about the meaning of federal law. In this case, however, the court granted certiorari in the face of a uniform understanding among circuit courts that the SEC may obtain disgorgement in federal court. But that was a pre-*Kokesh* understanding.

In their petition, Liu and Wang argue that Congress has expressly identified the forms of relief the SEC may seek in federal court enforcement actions—civil monetary penalties, injunctions, and equitable relief—and that disgorgement isn't one of them. See 15 U.S.C. §§77t(b), (d), 78u(d)(1), (3), (5). They argue that disgorgement is not a form of equitable relief, because while the purpose of equity is to restore the status quo, not punish the wrongdoer, the court held in *Kokesh* that SEC disgorgement is punitive. And petitioners stress that the award in their case raises many of the concerns that led to the court's decision in *Kokesh*. For one, the district court did not order the SEC to distribute the disgorged funds to the victims. For another, the district court failed to take into account nearly $16 million in legitimate business expenses that should have reduced the $27 million disgorgement amount—thus implicating the court's concern in *Kokesh* that disgorgement is sometimes ordered without consideration of a defendant's expenses that reduce the amount of illegal profit. 137 S.Ct. at 1643.

The SEC responds that Congress *has* authorized courts to order disgorgement. *First*, both the Securities Act of 1933 and the Securities Exchange Act of 1934 grant federal

courts power to "enjoin" violations. 15 U.S.C. §§77t(b), 78u(d)(1). And the Supreme Court held in the context of the Emergency Price Control Act of 1942 that a legislative grant of authority to "enjoin" statutory violations encompassed the power to order a defendant "to disgorge profits acquired in violation" of that statute. *Porter v. Warner Holding Co.*, 328 U.S. 395, 398-99 (1946). *Second*, the Sarbanes-Oxley Act of 2002 empowered courts hearing SEC enforcement actions to order "any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C. §78u(d)(5). The court has characterized disgorgement as an equitable remedy, see, e.g., *Kansas v. Nebraska*, 135 S. Ct. 1042, 1057 (2015), and thus, the SEC argues, Congress understood when enacting Sarbanes-Oxley that the grant of federal court authority to order "equitable relief" included authority to order disgorgement.

In reply, Liu and Wang contend that treating disgorgement as an equitable remedy cannot be reconciled with the court's decision in *Kokesh*. It would make little sense, they say, to treat disgorgement as a penalty for statute-of-limitations purposes, but as an equitable remedy for purposes of assessing whether a court can order it at all. Petitioners also note that Congress knows how to authorize disgorgement expressly: It did so in the context of SEC *administrative* proceedings. See 15 U.S.C. §78u-2(e). Its silence in the federal court context reflects its intent that disgorgement should not be available in that forum.

The case is set for argument in March, and will likely be decided by the end of June.

Potential Fallout

The SEC's power to seek disgorgement as an equitable remedy in federal court appears increasingly tenuous, given the court's grant of certiorari without a circuit split, the express reservation in *Kokesh*, and the skepticism several Justices expressed during oral argument in that case. It therefore seems unlikely that the court will leave the federal court disgorgement remedy undisturbed. More likely is that the court will either rule that such disgorgement is unavailable entirely, or at least limit the remedy in some way. The court could, for example, conclude that federal court disgorgement is allowed only where the disgorged amount is reduced by the defendant's legitimate business expenses and the recovered funds are returned to investors. A disgorgement remedy so refined might fit within the court's concept of an equitable remedy.

A decision barring SEC disgorgement in federal courts would have far-reaching ramifications. Disgorgement orders often arise from SEC settlements that are negotiated in the context of the available judicial remedies. The loss of that remedy could in many cases undermine the SEC's bargaining power and the overall settlement dynamics. The SEC would, of course, retain the power to seek disgorgement in administrative proceedings. But in view of persistent challenges to the structure and legality of SEC administrative adjudication, federal courts could soon become the SEC's preferred—or only—forum for prosecuting securities law violations. See, e.g., *Lucia v. SEC*, 138 S.Ct. 2044 (2018) (holding that SEC process for appointing Administrative Law Judges (ALJs) violated Constitution's Appointments Clause); *Cochran v. SEC*, No. 19-10396 (5th Cir. Sept. 24, 2019) (per curiam) (staying SEC administrative proceeding pending challenge to constitutionality of restrictions on removing SEC ALJs).