ALERT MEMORANDUM

Supreme Court to Consider Whether the SEC Has Authority to Seek Disgorgement in Federal Court Actions: Will the Court Further Prune the SEC's Enforcement Powers?

November 4, 2019

On November 1, 2019, the Supreme Court granted certiorari in *Liu v. SEC* to decide whether the Securities and Exchange Commission can obtain disgorgement as an equitable remedy in federal court enforcement actions. The certiorari grant in this case is unusual, because the circuit courts that have considered the issue have all agreed that the SEC can obtain disgorgement from a district court exercising its equitable authority. Depending on how the Court rules, this case could have major consequences for the SEC's enforcement program and even for the inherent equitable powers of Article III courts.

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Background

Liu involves the operation of a so-called EB-5 fund.[1] These funds offer lawful permanent residence opportunities to foreigners who make significant investments in the United States.[2] The defendants in *Liu* misappropriated for their personal use millions of dollars that had been invested in the EB-5 fund they operated, and the district court found that the defendants had violated Section 17(a) of the Securities Act of 1933 for false statements in the context of a securities offering.[3] The district court ordered the defendants to disgorge $26 million, the gross amount investors committed to the EB-5 fund.[4] The district court rejected defendants' argument that their expenses should be deducted—including lease payments, construction costs, and equipment manufacturing costs[5]—from their disgorgement, on the grounds that Ninth Circuit precedent dictates that the proper amount of disgorgement is the "entire proceeds from a scheme minus amounts paid to investors."[6]

The defendants petitioned the Supreme Court to challenge the SEC's power to obtain disgorgement, primarily in reliance on a 2017 decision, *Kokesh v. SEC*.[7] In that case the Supreme Court held that disgorgement awarded under the court's equitable power constituted a penalty, not a remedial measure, and was thus subject to a five-year statute of limitations under 28 U.S.C. § 2462.[8] In a footnote to its opinion, the Court expressly declined to address "whether courts possess authority to order disgorgement in SEC enforcement proceedings or . . . whether courts have properly applied disgorgement principles in this context."[9] Because no party had asked the Court to address that question, the footnote appeared to many an invitation to reconsider the legitimacy of disgorgement in SEC actions. Several challenges to the SEC's disgorgement awards ensued in the lower courts. Every court to consider the issue to date—including the Ninth Circuit, which upheld the disgorgement order here—has held that the SEC has the authority to seek (and district courts have the authority to grant) disgorgement, both because the federal securities laws authorize the SEC to seek injunctive relief in the district courts and because those courts have inherent equitable powers to craft appropriate remedies for wrongdoing.[10]

Now, the *Liu* petitioners argue that, because SEC disgorgement is a penalty under *Kokesh*, it does not constitute an injunctive or equitable remedy and therefore cannot be granted absent specific authorization from Congress.[11] To demonstrate the lack of such authority, petitioners point to the fact that Congress has expressly granted the SEC disgorgement authority only in cases brought before SEC administrative law judges.[12]

The U.S. Solicitor General, representing and joined by the SEC, counters by claiming that courts had the power to order disgorgement at the time of the

[1] Br. for Pet'r at 4, *Liu v. SEC*, No. 18-1501 (Sup. Ct. filed May 31, 2019).
[2] *Id.* at 3-4.
[3] *Id.* at 5.
[4] *Id*.
[5] *Id.* at 6.
[6] *SEC v. Liu*, 262 F. Supp. 3d 957, 975 (C.D. Cal. 2017), *aff'd*, 754 F. App'x 505 (9th Cir. 2018), *cert. granted*, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).
[7] *Kokesh v. SEC*, 137 S. Ct. 1635, 1644 (2017); *see also* Cleary Gottlieb's article *Supreme Court Applies Five-Year Statute of Limitations to SEC Disgorgement Claims* (June 6, 2017), available at https://www.clearygottlieb.com/~/media/organize-archive/cgsh/files/2017/publications/alert-memos/supreme-court-applies-fiveyear-statute-of-limitations-to-sec-6-6-17.pdf.
[8] *Id*. Approximately four years prior, the Supreme Court also considered the limits of the SEC's penalty authority in *Gabelli v. SEC*, 568 U.S. 442 (2013). In that case, which was successfully argued by Cleary Gottlieb attorneys, the Supreme Court held that the time for the SEC to bring an action under the five-year statute of limitations for "the enforcement of any civil fine, penalty or forfeiture" began to run not when the SEC "discovered" the underlying conduct, but when the conduct occurred. *Id.* at 454.
[9] *Id.* at 1642, note 3.
[10] Br. For Resp't at 9, *Liu v. SEC*, No. 18-1501 (Sup. Ct. filed Sept. 24, 2019).
[11] Br. for Pet'r at 10, *Liu v. SEC*, No. 18-1501 (Sup. Ct. filed May 31, 2019).
[12] *Id.* at 9, note 3.

founding and that therefore Article III's grant of judicial power should be understood to convey with it the power to order disgorgement.[13] The Solicitor General also argues that Congress has repeatedly amended the securities laws in ways that assume district courts have the power to award disgorgement.[14] Finally, the Solicitor General argues that *Kokesh* only characterized disgorgement as a penalty for statute of limitations purposes, and that a remedy may qualify as equitable relief for some purposes and a penalty for others.[15]

It is expected that arguments will take place early in 2020, with a decision to come by summertime.[16]

Key Takeaways

The Supreme Court's grant of the petition in *Liu* is notable. The courts have assumed that district courts have the inherent equitable authority to grant disgorgement since the 1970 *Texas Gulf Sulphur* decision.[17] Since *Texas Gulf Sulphur*, twelve circuit courts have agreed that the district courts have this authority.[18] There is thus no circuit split on the issue. In fact, perhaps thinking that the *Liu* petition had no real chance of being granted, the Solicitor General initially waived his right to file an opposition, filing only after being expressly invited to do so by the Court.[19]

A ruling that the SEC cannot obtain disgorgement from federal courts would have a significant impact on the SEC's enforcement power. *Kokesh* only limited the amount of time the SEC had to bring an action seeking disgorgement. It did not limit the actual relief the SEC could obtain if it successfully proved a violation. *Liu*, by contrast, directly challenges the SEC's remedial authority and one of the SEC's most important remedies. According to Division of Enforcement Co-Director Steven Peikin, the *Kokesh* decision required the SEC to forgo as much as $800 million in disgorgement in 2018.[20] A ruling that the SEC cannot seek disgorgement at all in federal court actions would have a much more dramatic effect. In 2018 alone, the agency collected over $2.5 billion in disgorgement, compared to $1.4 billion in civil money penalties.[21]

Even before the case is decided, this grant of certiorari could have consequences for pending cases and investigations. The SEC settles the vast majority of its cases before litigation.[22] In negotiating settlement agreements, one of the SEC's bargaining chips is the potential disgorgement amounts it can pursue in

[13] Br. For Resp't at 4–5 , *Liu v. SEC*, No. 18-1501 (Sup. Ct. filed Sept. 24, 2019).
[14] *Id.* at 6.
[15] *See id.* at 8 ("A remedy thus can qualify as a form of equitable relief even though it might also be considered 'penal' for some purposes."). The Solicitor General also argues that the petitioners waived their argument that disgorgement is not available at all by failing to raise it at the district or appellate court level. *Id.* at 13. While the Supreme Court granted certiorari notwithstanding this, it is possible that the Court will find, on further briefing, that this waiver is an issue.
[16] Amy Howe, *Justices Add Securities-Law Case to Merits Docket, Extend DACA Argument*, SCOTUSBlog (Nov. 1, 2019), https://www.scotusblog.com/2019/11/justices-add-securities-law-case-to-merits-docket-extend-daca-argument/.
[17] *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd in part, rev'd and remanded in part*, 446 F.2d 1301 (2d Cir. 1971).
[18] *See, e.g.*, *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997). The Federal Circuit has expressed no opinion, but it generally does not hear securities cases.
[19] Nonetheless, the Supreme Court granted certiorari, indicating that at least four Justices believe the question of disgorgement authority is worth examination. This was perhaps foreshadowed during oral arguments in *Kokesh*, when five justices raised questions about the SEC's general authority to seek disgorgement. *See* Br. for Pet'r at 9, *Liu v. SEC*, No. 18-1501 (Sup. Ct. filed May 31, 2019). For example, Chief Justice Roberts noted that "the SEC devised this remedy or relied on this remedy without any support from Congress." *Id.*
[20] Steven Peikin, Co-Director, Div. of Enf't, Sec. & Exch. Comm'n, Remedies and Relief in SEC Enforcement Actions (Oct. 3, 2018), https://www.sec.gov/news/speech/speech-peikin-100318.
[21] Div. of Enf't, Sec. & Exch. Comm'n, *2018 Annual Report* at 11, available at https://www.sec.gov/enforcement-annual-report-2018.pdf. This ratio is consistent with that in previous years.
[22] *Id.* at 14.

federal court. The certiorari grant could reduce the SEC's leverage in settlement negotiations, given the possibility that the Supreme Court will curtail or eliminate the disgorgement remedy in federal court actions. The certiorari grant may also cause the SEC to question the settlement value of outstanding litigations and the merits of pursuing more marginal investigations where disgorgement would be a key remedy. On the other hand, the SEC may argue that it is unlikely the Court will overturn decades of settled jurisprudence, and in any event, the agency has flexible powers to seek significant civil penalties other than disgorgement.

An additional consequence—should the Court rule against the SEC—may be to compel the SEC to bring more litigated cases in administrative proceedings. Congress has expressly granted the SEC the power to seek and obtain disgorgement before administrative law judges.[23] However, the constitutional viability of the SEC's administrative forum has been under attack for the last several years, and certain aspects of the SEC's administrative practice have been thrown into doubt by recent Supreme Court decisions.[24] Moreover, there are certain types of actions, such as asset freezes, that cannot as a practical matter be brought in administrative proceedings. Therefore, even absent any constitutional issues, redirecting matters to administrative proceedings would not fully address the issue.

Two other points bear noting. First, it is possible that the Supreme Court will use *Liu* to limit, rather than entirely eliminate, the type of disgorgement orders the SEC can obtain in federal court. The *Liu* petitioners argue that the award in their case—like the award in many other cases—exceeds their net profit, is payable to the United States government, and will not go to the victims. Those same factors convinced the Court in *Kokesh* that the disgorgement was penal under § 2462. It is possible that the Court might take a similar approach in *Liu*, ruling in a way that preserves the ability of the district courts to enter disgorgement awards in those SEC cases where money would be restored to victims rather than going to the government.

Second, any limit on the SEC's disgorgement authority may prompt Congressional action. After *Kokesh* limited the SEC to a five-year window for disgorgement, the House of Representatives Financial Services Committee introduced legislation that would create a fourteen-year statute of limitations on SEC disgorgement.[25] The bill enjoys bipartisan support and passed through the Financial Services Committee by a vote of 49-5.[26] It is possible that the notion of wrongdoers being able to keep the fruits of their fraud may spur similar attempts at legislative change.

[23] Securities Exchange Act of 1934, 15 U.S.C. § 78u–2(e).
[24] *See Lucia v. SEC*, 138 S. Ct. 2044 (2018); *see also* Cleary Gottlieb's article *Supreme Court Holds that SEC Administrative Law Judges Are Unconstitutionally Appointed* (June 26, 2018), available at https://www.clearygottlieb.com/-/media/files/alert-memos-2018/2018_06_26-sec-administrative-law-judges-are-unconstitutionally-appointed-pdf.pdf.
[25] H.R. 4344 116th Cong. (2019); s*ee also* Tracey Longo, *House Bill Would Make It Easier To Recoup Money From Fraudsters*, Financial Advisor, Sept. 25, 2019, https://www.fa-mag.com/news/house-bill-would-make-it-easier-to-recoup-money-from-fraudsters-51844.html.
[26] Tracey Longo, *House Bill Would Make It Easier To Recoup Money From Fraudsters*, Financial Advisor, Sept. 25, 2019, https://www.fa-mag.com/news/house-bill-would-make-it-easier-to-recoup-money-from-fraudsters-51844.html.

Conclusion

Even after *Kokesh*, disgorgement has remained a powerful SEC enforcement tool, representing the bulk of the money obtained by SEC enforcement orders. *Liu* threatens to deprive the SEC of this tool in its federal court actions. This would somewhat weaken, at least until potential congressional action, the SEC's hand in federal court actions, perhaps leading to less onerous settlement and litigation outcomes. While the possible outcomes of the Court's grant of certiorari are uncertain, *Liu* represents the possibility of another Supreme Court decision that reins in powers long viewed as uncontroversial exercises of the SEC's enforcement authority.[27]

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[27] This Alert Memorandum was prepared with the assistance of Benjamin Rosenblum and William Baldwin.