

# Securities Litigation Alert

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## *Liu v. SEC* – Supreme Court Establishes Important Limitations on SEC Disgorgement

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### Key Points:

- In *Liu v. SEC*, No. 18-1501, the Supreme Court upheld the SEC's ability to obtain disgorgement as a form of equitable relief in civil actions in federal court, pursuant to 15 U.S.C. § 78u(d)(5).
- However, the Court established important limitations on SEC disgorgement going forward: (a) the award must be "for the benefit of investors," which usually means that funds must be returned to victims, (b) disgorgement should not exceed a wrongdoer's net profits, after deducting legitimate expenses, and (c) disgorgement imposed against multiple persons under a joint-and-several liability theory may not be appropriate.
- The Court's decision leaves open several questions, including whether the SEC's common practice of distributing disgorged profits to the U.S. Treasury, rather than to victims, exceeds the scope of equitable relief authorized under Section 78u(d)(5).

### Supreme Court Opinion in *Liu v. SEC*

On June 22, 2020, the U.S. Supreme Court resolved a critical question left unanswered since its decision in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017)—whether, and to what extent, the U.S. Securities and Exchange Commission (SEC) may seek disgorgement in civil actions pursuant to the SEC's authority to seek "equitable relief" under 15 U.S.C. § 78u(d)(5). *Liu v. SEC*, No. 18-1501, has been closely watched by white-collar practitioners because, for decades, the SEC has relied on disgorgement as one of its primary remedial tools. (See our previous posts on Liu's [certiorari petition](#) and [oral arguments](#)). In an 8-1 opinion authored by Justice Sotomayor, the Supreme Court delineated the SEC's disgorgement power in civil actions, holding the SEC is permitted to seek a disgorgement award that does not exceed a wrongdoer's net profits and is awarded to benefit victims. The Court also indicated that while equitable relief generally requires defendants to be individually liable for their profits, joint-and-several liability could be appropriate where defendants were partners in wrongdoing.

*Liu* arose from a fairly straightforward investment fraud scheme. As alleged by the SEC, the defendants had raised approximately \$27 million from Chinese investors

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under the EB-5 Immigrant Investor Program (the “EB-5 Program”), which allows foreign citizens to obtain visas in exchange for investments in the United States. However, instead of investing the funds in the cancer treatment center contemplated by the offering, the defendants misappropriated most of the money. The district court found that the defendants violated Section 17(a)(2) of the Securities Act of 1933, and ordered them to disgorge the entire amount raised, minus funds remaining in their corporate accounts. *SEC v. Liu*, 262 F. Supp. 3d 957, 976 (C.D. Cal. 2017). The defendants objected to the amount of disgorgement, arguing that they should receive an offset for their business expenses. The district court disagreed and found that the sum was a “reasonable approximation of the profits causally connected to [their] violation.” *Id.* The district court also imposed \$8.2 million in civil penalties and permanently enjoined the defendants from future solicitation of EB-5 Program investors.

After the district court issued its decision, the Supreme Court held in *Kokesh* that disgorgement in the securities enforcement context is a “penalty” within the meaning of the applicable statute of limitations, 28 U.S.C. § 2462. In a footnote in *Kokesh*, the Supreme Court specifically declined to address whether, in light of the determination that disgorgement is punitive, “courts possess authority to order disgorgement in SEC enforcement proceedings.” On appeal in *Liu*, the defendants argued that, in light of *Kokesh*, the SEC lacked authority to obtain disgorgement. The Supreme Court rejected this argument.

The Court held that, notwithstanding *Kokesh*, disgorgement is a form of equitable relief authorized by Section 78u(d)(5). Opinion at 5 (internal citation omitted). After reviewing precedents, Justice Sotomayor’s opinion explained that courts have long been authorized to strip wrongdoers of their ill-gotten gains in equity, but in order to avoid transforming the equitable remedy into an impermissible punitive sanction, courts restrict that remedy to an individual wrongdoer’s net profits to be awarded for victims. *Id.* at 6-9. Separately, the Court expressed caution about the availability of joint-and-several liability for disgorgement, directing the lower courts to determine if the married petitioners could be found liable for profits as partners in their wrongdoing or if individual liability was required. *Id.* at 18. Finally, the Court directed the lower courts to examine whether certain expenses by the petitioners (e.g., for cancer treatment equipment) had value independent of fueling the fraudulent scheme, and should therefore be deducted from the disgorgement award. *Id.* at 19-20.

### ***Liu* Cabins the Equitable Relief the SEC May Obtain**

Although the Court’s decision in *Liu* allows the SEC to continue to seek disgorgement as a key part of the agency’s remedial “toolbox,” there are important limits going forward. As the Court’s opinion makes clear, disgorgement awards must comport with the principles of equity in three ways: (1) returning funds to victims; (2) generally imposing liability based on a defendant’s own conduct, as opposed to a theory of joint-and-several liability; and (3) deducting legitimate expenses from any disgorgement award. *Id.* at 14.

As a matter of practice, the SEC often deposits disgorgement proceeds with the U.S. Treasury. *Id.* at 14. Notably, the Supreme Court left open the question of whether, and to what extent, this practice satisfies the SEC’s obligation under Section 78u(d)(5) to award relief “for the benefit of investors.” *Id.* at 17. The Court declined to decide the issue because the defendants had not actually paid over any money, and accordingly,

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the district court did not enter an order directing that disgorgement proceeds be paid over to the Treasury. *Id.* at 17. Going forward, however, this practice will be subject to further litigation in cases where it is difficult for the SEC to ascertain the identity of specific victims, or the harm suffered by those victims, as is often the case with Foreign Corrupt Practices Act and insider trading violations. In such cases, the SEC likely will have to argue the impracticality of identifying victims for disgorgement purposes or, potentially, forego disgorgement altogether in favor of seeking higher civil money penalties.

Separately, *Liu* introduces a new variable into the determination of remedies for a securities law violation by only allowing the SEC to obtain disgorgement of a defendant's net profits. Under *Liu*, the SEC staff will now have the added investigative burden of establishing the defendant's legitimate business expenses in order to calculate a net profit amount for disgorgement purposes. Moreover, limiting disgorgement to net profits will almost certainly result in smaller awards.

Finally, the Court imposed limits on the SEC's ability to obtain disgorgement under a theory of joint-and-several liability. Although the Court allowed for joint liability "for partners engaged in concerted wrongdoing," in many cases the SEC may be hard pressed to establish that the parties' misconduct is sufficiently intertwined in order to justify disgorgement based on more than the individual's own conduct. This may have particular importance in tipper-tippee insider trading cases, to which the *Liu* opinion referred, where the SEC commonly requires tippers to "disgorge" profits earned by tippees, even though the tipper may have received nothing. Going forward in such cases, the SEC will, at a minimum, need to prove a "concerted" effort to obtain disgorgement from tippers. This will be challenging in cases involving complex chains of tipping, where different members of the chain typically have little or no interaction with one another.

### ***Liu's* Application to SEC Administrative Proceedings**

The *Liu* decision leaves open an important question regarding disgorgement in SEC administrative proceedings. As noted in Justice Thomas's dissent, it is uncertain whether disgorgement in SEC administrative proceedings, which is authorized under 15 U.S.C. § 77h-1(e), will be subject to the same limitations that the Court defined for disgorgement in federal court actions under Section 78u(d)(5). Thomas, J. dissenting, at 8. However, the majority's opinion in *Liu* suggests that the same principles would also apply in administrative proceedings. For example, the Court observed that references to traditionally equitable remedies such as disgorgement in statutes such as Section 77h-1(e), "must, absent other indication, be deemed to contain the limitations upon its availability that equity typically imposes." Opinion at 14 (internal quotations omitted).

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