Supreme Court Misses Its Chance To Define Limits Of SEC's Enforcement Authority

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Earlier this week the United States Supreme Court issued its third opinion in seven years clarifying the limits of monetary sanctions imposed in enforcement actions brought by the U.S. Securities and Exchange Commission (SEC). Like the Court's two earlier decisions, *Liu v. Securities and Exchange Commission* confirmed that the statutory remedies available to the SEC are subject to the same constraints as similar remedies recognized under common law. Unlike the Court's two earlier decisions, though, *Liu* established no new temporal limitations on the SEC's ability to impose those statutory remedies in SEC enforcement actions. For this reason, and considering that the primary holding of the case was something of a forgone conclusion, *Liu* was a missed opportunity.

The Lower Court Decisions

Liu began as one of several SEC enforcement actions arising out of the federal government's EB-5 Immigrant Investor Program. Defendant Charles Liu raised $27 million through the program ostensibly to build and operate a proton therapy cancer treatment center in southern California. Instead of building a therapy center, Liu funneled most of the money to himself, his wife and companies associated with them and used it to pay himself and his wife millions of dollars in "salary," among other unauthorized expenses. The SEC sued Liu, his wife and the companies for violations of the anti-fraud provisions

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of the Securities Act and Securities Exchange Act.

As part of its order granting the SEC's motion for summary judgment on its Securities Act claims, the district court ordered the defendants to disgorge the ill-gotten gains they made as a result of their fraud. For their part, the defendants did "not directly argue that disgorgement [was] inappropriate . . . rather they challenge[d] the amount the SEC request[ed]." The proper measure of disgorgement, they believed, was the total amount of money raised from investors, less the amount of money left in the investment funds after their fraud was discovered, *and* less the amount of the defendants' "legitimate business expenses." In declining to adopt the defendants' definition of disgorgement the court relied on the Ninth Circuit Court of Appeals' decision in *Securities and Exchange Commission v. JT Wallenbrock & Assocs.*, holding that it "would be unjust to permit the defendants to offset against the investor dollars they received the expenses of running the very business they created to defraud those investors into giving the defendants the money in the first place."

The defendants appealed the summary judgment order on various grounds, including that "[t]he federal courts are without power to award penalties absent explicit congressional authority . . . . To the extent the district court intended to grant [the SEC] . . . disgorgement as an equitable remedy, the court erred because in fact it awarded disgorgement also as a penalty." More specifically, the defendants argued "that the district court's order that they disgorge . . . the total amount they raised from their investors . . . less the amount left over and available to be returned . . . was erroneous." Relying on the Supreme Court's 2017 decision in *Kokesh v. Securities and Exchange Commission*, the defendants reasoned that "the district court lacked the power to order disgorgement in this amount" because the disgorgement award included all the funds received by Liu and his wife, not just the amount of their unjust enrichment. By refusing to deduct their "legitimate business expenses" from the total disgorgement award, the defendants believed, the court ignored the well-settled definition of disgorgement as "a reasonable approximation of *profits* causally connected to the violation." In other words, because "expenses" cannot be "profits," they have no place in the disgorgement calculus.

In an unpublished opinion a panel of the Ninth Circuit Court of Appeals sided with the district court rather than the defendants. The court cited *JT Wallenbrock & Assocs*. to support its holding that "the proper amount of disgorgement in a scheme such as this one is the entire amount raised less the money paid back to the investors." In passing, the court also rejected the defendants' more general claim that the district court lacked authority to impose disgorgement at all insofar as disgorgement served as a penalty rather than an equitable remedy—an issue the Supreme Court raised obliquely the year before in *Kokesh*, but only to emphasize that the *Kokesh* decision was not meant to express an opinion about the scope of courts' authority to order disgorgement in SEC enforcement cases.

Kokesh and *Gabelli*

The disgorgement issue raised by the defendants in *Liu*, and the one the Supreme Court granted certiorari to resolve, has its roots in two earlier Supreme Court cases addressing the limitations on monetary remedies typically sought in SEC enforcement actions. In *Kokesh*, cited by Liu and his co-defendants, the Supreme Court considered whether 28 U.S.C. § 2462, the omnibus five-year statute of limitations applicable to federal civil penalties claims, applied to SEC claims for disgorgement. Departing from the consensus that had evolved over many years in the lower courts, the Court held that it does. The decision was based in large part on the language of 28 U.S.C. § 2462 itself, which limits the provision's reach to actions "for the enforcement of any civil fine, penalty, or forfeiture." In an opinion by Justice Sotomayor, a unanimous Court held that "[d]isgorgement in the securities-enforcement context is a 'penalty' within the meaning of § 2462, and so disgorgement actions must be commenced within five years of the date the claim accrues."

Kokesh, in turn, tied up one of the loose ends left over from the Supreme Court's 2013 decision in *Gabelli v. Securities and Exchange Commission* which, like *Kokesh*, scuttled what appeared to be settled case law governing the application of 28 U.S.C. § 2462 to claims for monetary penalties in SEC enforcement actions. In an opinion by Chief Justice Roberts, the Court held that the "discovery rule," which delays the accrual of a plaintiff's claim until it is discovered, or could have been discovered, by the plaintiff, could not be applied to delay the accrual of a cause of action brought by the government to recover civil monetary penalties, at least where those penalties did not stem from an injury to the government itself. The decision was based in part on the Court's reluctance to extend the protection of the discovery rule, which historically had been invoked for the benefit of private parties, to a government agency. "Unlike the private party who has no reason to suspect fraud," the Court reasoned, "the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit."

The Supreme Court's Decision in *Liu v. Securities and Exchange Commission*

In *Liu*, the Supreme Court set itself the limited goal of answering the "antecedent question" it had "reserved" for itself in *Kokesh*: "whether, and to what extent, the SEC may seek 'disgorgement' in the first instance through its power to award 'equitable relief' " under Section 21(d)(5) of the Securities Exchange Act. The Court's holding was therefore equally limited; it decided only that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under" Section 21(d)(5).

To reach this conclusion, the Court first sought to determine whether, as a general matter, equitable disgorgement "falls into those categories of relief that were typically available in equity." The Court answered this question in the affirmative, but went on to observe that, while

[e]quity courts have routinely deprived wrongdoers of their net profits from unlawful activity, * * * they also recognized the countervailing equitable principle that the wrongdoer should not be punished by pay[ing] more than a fair compensation to the person wronged . . . . [C]ourts consistently restricted awards to net profits from wrongdoing after deducting legitimate expenses. Such remedies, when assessed against only culpable actors and for victims, fall comfortably within those categories of relief that were typically available in equity.

Seeking to expand this traditional understanding of disgorgement for the purposes of applying Section 21(d)(5), the SEC argued that, historical definitions notwithstanding, Congress intended the SEC's equitable jurisdiction to go *beyond* the limits imposed by the common law. The Court rejected this view, and instead determined that “these longstanding equitable principles” were incorporated into Section 21(d)(5), and that Congress implicitly “prohibited the SEC from seeking an equitable remedy in excess of a defendant’s net profits from wrongdoing” when it enacted that provision.

But the Court declined to go further and rule on the more nuanced arguments raised by the parties, including whether petitioners’ “disgorgement award [was] unlawful because it fail[ed] to return funds to victims” of petitioners’ fraud, and because it did not “deduct business expenses from the award.” The Court justified its decision not to resolve these issues by explaining that, “[b]ecause the parties focused on the broad question [of] whether any form of disgorgement may be ordered and did not fully brief these narrower questions, we do not decide them here.”

Afterthoughts

Although *Liu* confirmed that a disgorgement award that “does not exceed a wrongdoer’s net profits” is permissible under the Exchange Act, it is hard to believe that that result was ever seriously in doubt. Among the SEC staffers and SEC defense attorneys I canvassed before the decision was issued I was unable to find any who thought that the SEC’s disgorgement remedy was in danger of being abolished. In fact, given its text and limited scope, it is difficult to escape the conclusion that *Liu* was intended primarily to put the lid back on the Pandora’s Box that *Kokesh* opened when it raised—as an aside—the possibility that the validity of the SEC’s disgorgement remedy was open to question. Most puzzling was the Court’s refusal to resolve the one objective question that would have made *Liu* an important decision: in what specific circumstances does an SEC disgorgement award “exceed a wrongdoer’s net profits” and become an impermissible penalty? Instead, *Liu* answered a question no one was asking.

Like *Kokesh* before it, *Liu* also left unanswered questions about the scope of other important SEC enforcement remedies, namely, whether injunctive relief—not just civil penalties and disgorgement—is also subject to a five-year statute of limitations in SEC cases. If so, the SEC would be without a meaningful remedy in nearly all SEC fraud actions commenced more than five years after the occurrence of the conduct underlying the suit. Nor did *Liu* clarify whether equitable tolling doctrines such as fraudulent concealment are also subject to the five-year cap announced in *Gabelli* and confirmed in *Kokesh*, an omission which leaves open the possibility that the SEC can safely ignore the limitations established by those cases in the run-of-the-mill SEC fraud case. In failing to address these questions, which surface regularly in SEC litigation, the Court missed its opportunity to finish the work it began in those earlier cases and to give the final word on the permissible lifespan of civil enforcement actions.

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