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Justices' Liu Ruling Creates More Questions Than Answers

By **Dean Seal**

Law360 (June 23, 2020, 10:35 PM EDT) -- Monday's highly anticipated U.S. Supreme Court opinion in Liu v. SEC answered one basic question about the top securities regulator's disgorgement powers — and punted a host of more complicated issues that one expert says will be "alive and kicking throughout the courts for a long time to come."

The high court handed down an 8-1 opinion finding that the U.S. Securities and Exchange Commission can obtain disgorgement through enforcement actions in district courts as a form of equitable relief, a remedy that is based on principles of fairness rather than statute and has historically excluded punitive sanctions.

But the decision also reined in the SEC's ability to collect disgorgement by declaring that the award must be no more than a wrongdoer's illicit profits, from which "legitimate expenses" must be deducted, and that it must flow to wronged investors.

John W. Berry of Munger Tolles & Olson LLP, who represented the SEC in the district court case that became Liu v. SEC on appeal, said the regulator has already been scaling back its use of disgorgement in ways that accommodate these new limits, but noted that Monday's ruling leaves open three big questions about the remedy that defendants in SEC actions will now undoubtedly evoke when fighting to scale back disgorgement.

In their high court challenge, Charles Liu and his wife, Xin Wang, had argued that disgorgement — like the almost $27 million award ordered against them in 2017 — crossed the bounds of traditional equitable relief for three reasons: It failed to return money to victims, imposed joint-and-several liability on Wang for the ill-gotten gains of her husband, and it did not deduct business expenses.

The justices said Monday that they would not decide those narrower issues and would instead "guide the lower courts' assessment of these arguments on remand." But as several experts told Law360, the high court's opinion leaves plenty of ambiguity in how those three issues, and several others, can be addressed in the remanded Liu case and beyond.

"You're going to have to have years and years of battling this out, and then eventually it might have to go to the Supreme Court again," Berry said with a chuckle. "Because different courts aren't going to agree on how to do this."

Can Disgorged Funds Go to the Treasury?

Perhaps the most glaring open question created by the opinion contemplates whether the agency is overstepping its authority by allowing disgorgement to be deposited with the U.S. Department of the Treasury when disbursement back to investor victims isn't feasible.

The practice hadn't actually been used in the Liu case, which has a court-appointed receiver in place to collect disgorged funds for victims, but it became a broader topic for argument over whether disgorged funds deposited with the Treasury were collected by the SEC "for the benefit of investors." The SEC argued that they were, noting that disgorgement awards were used to fund the agency's fruitful whistleblower program, while Liu and Wang argued to the contrary, given that the funds don't actually make it into the hands of victims.

Presented with both sides, the majority opinion found that disgorgement "must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains" — only to then kick the admittedly "open question" to lower courts.

Justice Clarence Thomas, the lone dissenting justice in the case, was quick to call out what he saw as an inherent problem with the high court's reticent approach to the issue and lack of guidance to lower courts, saying that the majority should have at least tried to identify "the circumstances in which the government may keep the money."

"Instead, the court asks lower courts to improvise a solution," Justice Thomas said. "If past is prologue, this uncertainty is sure to create opportunities for the SEC to continue exercising unlawful power."

No other member of the court sided with Justice Thomas, but he isn't alone in his frustration. Susan Hurd, a securities litigation partner at Alston & Bird LLP, told Law360 she would have liked the majority to provide more clarity on that point.

The SEC will undoubtedly face new risks if it chooses a "business as usual" approach to disgorgement going forward, Hurd said, but the Supreme Court's ruling leaves significant room for interpretation as to whether disgorged funds can ever again make their way to the U.S. Treasury.

"The court certainly left open the possibility that disgorgement funds must be returned to investors unless it is impossible to do so — or perhaps must be returned without exception, full stop, or the relief will cease to qualify as equitable relief available to the SEC in federal court," Hurd said in an email. "The court definitely kicked the can to the lower courts to grapple with this issue first as an initial matter."

Can the SEC Seek Disgorgement for Insider Trading?

Liu v. SEC is a relatively straightforward fraud case in which Liu and Wang sought investments for an EB-5 visa program only to later misappropriate funds. But disgorgement is a remedy the SEC uses in other types of securities fraud cases as well, and the Supreme Court's decision Monday could change that, experts say.

While somewhat ambiguous, the majority opinion does state that the equitable nature of disgorgement "generally requires the SEC to return a defendant's gains to wronged investors for their benefit." That poses an obvious question for insider trading cases.

"What are you supposed to do with disgorged profits from insider trading? There's nobody to return it to," Berry, of Munger Tolles, told Law360 in an interview.

The lack of easily identifiable victims in SEC enforcement actions is not restricted to insider trading. Hogan Lovells partner Ann Kim, former senior counsel for the SEC's enforcement division, said the same issue will likely arise in actions involving Foreign Corrupt Practices Act violations.

"The court's ruling creates a huge issue for the SEC in seeking disgorgement in FCPA cases, where there is no readily identifiable harmed investor," Kim said in an email. "In those cases, how will the SEC prove who the harmed investors are, and how much they each receive?"

Another aspect of Monday's opinion could be troubling for insider trading cases. The justices concluded that the SEC could only seek disgorgement of illicit profits that an individual defendant received and could not impose joint-and-several liability on the wrongdoer's associates, even if they received illicit profits, unless the SEC proves the defendant and the associate "engaged in concerted wrongdoing."

According to Gerald Hodgkins, a partner at Covington & Burling LLP and former associate director of the SEC's enforcement division, the regulator's current practice of seeking a tippee's profits from a tipper in insider trading cases likely won't fly anymore, since Monday's opinion suggests that "requiring one party to pay back the ill-gotten gains of another amounts to a penalty."

Hodgkins said the SEC can still try to prove a tipper and tippee were indeed engaging in "concerted wrongdoing," such as when a tipper provides insider information to a family member or receives a kickback from a tippee.

"That said, [given] the court's use of 'remote, unrelated tipper-tippee arrangements' as the example it provided for when collective liability would not be appropriate, it seems unlikely that traditional tipper-tippee cases would meet the standard articulated by the court for when one wrongdoer can be held responsible for the profits of another," Hodgkins said in an email.

How Does the Kokesh Decision Square With Liu?

Liu and Wang's challenge of the SEC's disgorgement authority was based on the Supreme Court's 2017 decision in Kokesh v. SEC, which found that disgorgement constituted a penalty rather than an equitable remedy for statute of limitations purposes. The justices declined at the time to explicitly state whether disgorgement could still be imposed at all under securities law as a form of equitable relief, which has historically excluded punitive sanctions, leading Liu and Wang to direct the question back to the bench.

In answering that question Monday, the justices set out the guardrails that would apparently bring SEC disgorgement back into the realm of being a traditional equitable remedy — which does not carry a statute of limitations. So can the SEC, as long as it abides by the Supreme Court's parameters from Liu, seek disgorgement while avoiding the five-year statute of limitations established under Kokesh?

"What I can say with a high degree of certainty is the SEC is sure to make that argument," said Nick Morgan, a partner at Paul Hastings LLP and former senior trial attorney at the SEC. "However, unless the SEC changes the way it has imposed disgorgement for decades, it will continue to be punitive."

Morgan told Law360 that even if disgorgement is sought by the SEC as an equitable remedy, meaning in adherence to the high court's conditions under Liu, defendants may still argue that Kokesh found disgorgement to nonetheless serve a remedial purpose in SEC enforcement actions. Even if every dollar collected went to victims, he said, SEC disgorgement is arguably a remedy for a violation committed against the U.S. and intended to "label defendants wrongdoers."

On the flip side, because the Liu decision aims to bring SEC disgorgement into line with "traditional equity jurisprudence," Barnes & Thornburg LLP partner Trace Schmeltz told Law360 that the agency "may not face a statute of limitations when seeking disgorgement of net profits — or disgorgement of all money raised in matters involving no legitimate business."

As the majority opinion in Liu notes, the Kokesh case examined a version of SEC disgorgement that "seemed to exceed the bounds of traditional equitable principles," but Justice Sonia Sotomayor went on to say that the Kokesh decision "has no bearing on the SEC's ability to conform future requests for a defendant's profits to the limits outlined in common-law cases awarding a wrongdoer's net gains."

"It seems to me this opens the door for a straight equitable disgorgement (one that is for net profits only) that goes back to harmed parties (those defrauded) that is demonstrably not 'punitive' and, thus, not subject to the [five-year statute of limitations]," Schmeltz said in an email.

Kurt Wolfe, an associate at Troutman Sanders LLP, similarly told Law360 that Monday's high court opinion seems to have created two categories of disgorgement: "SEC disgorgement" that has a punitive effect and carries a five-year statue of limitations, and "traditional disgorgement" that is purely equitable in nature and carries no statute of limitations.

"The upshot: if you can craft a disgorgement remedy within the bounds of Liu, there may be no time bar," Wolfe said in an email.

But as with Kokesh, the Liu ruling leaves much to be nailed down — and like Kokesh, the issues unresolved by Monday's opinion may find their way back to the high court for an answer.

"The Supreme Court didn't answer a lot of questions," Berry told Law360. "It answered the basic, easy question, but left open so many questions that this is going to be an issue that's alive and kicking throughout the courts for a long time to come."

--Editing by Jill Coffey.