

Supreme Court to Review SEC's Authority to Seek Disgorgement

The Supreme Court has agreed to hear a case that challenges the SEC's authority to pursue disgorgement in civil enforcement actions.

Key Points:

- The upcoming case will resolve a split of authority on whether the SEC has exceeded its power in pursuing disgorgement in civil enforcement actions.
- In a prior Supreme Court case, *Kokesh v. SEC*, the Court addressed and classified disgorgement as a penalty for statute-of-limitations purposes, but expressly declined to decide whether the courts have the power to order disgorgement in SEC enforcement cases.
- A final decision against the SEC will likely have tremendous fiscal and practical implications for the SEC and for other executive agencies, including the FTC.

Introduction

On November 1, 2019, in *Liu v. SEC*,¹ the Supreme Court of the United States granted a petition for a writ of certiorari to determine whether the Securities and Exchange Commission (SEC) has the authority to pursue disgorgement in civil enforcement proceedings. The defendants-petitioners, in challenging a district court order in favor of the SEC granting disgorgement, set forth several persuasive arguments against the SEC's authority, including the incompatibility of lower court precedent with the Supreme Court's 2017 holding in *Kokesh*,² the need for guidance in the lower courts, and the confusion over the availability of "equitable disgorgement" for other agencies operating under similarly worded statutes.³

In the *Kokesh* ruling, the Supreme Court held that disgorgement was considered a penalty and thus subject to the applicable federal statute of limitations.⁴ The Court's decision, however, left unaddressed outstanding questions that have unsettled lower courts. First, is disgorgement categorically considered a penalty or an equitable remedy? Second, absent statutory authority, does the SEC even have the authority to pursue disgorgement in federal court enforcement actions? The *Liu* case is positioned to answer these important questions with a decision that is sure to have lasting implications for both the SEC and other federal agencies.

Background of the SEC and Its History With Disgorgement

Under the Securities Act of 1933 and the Securities Exchange Act of 1934, the SEC could "bring an action in the proper district court" whereby "a permanent or temporary injunction or restraining order" could be granted.⁵ The plain meaning of the statute seemed to limit the statutory remedies to only

injunctions for SEC enforcement actions. In the 1970s, however, the SEC successfully urged courts to “order disgorgement as an exercise of their ‘inherent equity power to grant relief ancillary to an injunction.’”⁶ The supplemental remedy serves as a mechanism to “deprive ... defendants of their profits in order to remove any monetary reward for violating securities laws” and to “protect the investing public by providing an effective deterrent to future violations.”⁷ In 1990, Congress passed a new law that authorized the SEC to seek disgorgement in administrative proceedings.⁸ But Congress did not provide statutory authority for the SEC to obtain disgorgement in civil enforcement proceedings filed in federal district court.⁹

Defendants and scholars alike question the legitimacy of disgorgement orders in SEC enforcement actions brought in court absent explicit statutory authority.¹⁰ Some courts suggest that the authority is derived from broad equity jurisdiction in the securities laws.¹¹ Other courts reason that disgorgement is an “ancillary equitable power available to courts under the statutory provisions” that give courts the authority to issue injunctions in securities law cases.¹² Regardless of where the courts derive such power, the SEC frequently seeks and obtains disgorgement as a remedy in federal district court actions.

Landmark Supreme Court Decision on Disgorgement

In April 2017, the Supreme Court decided *Kokesh v. SEC*, holding that disgorgement was akin to a penalty for statute-of-limitations purposes.¹³ However, the Court did not guide the lower courts in addressing whether the classification of disgorgement as a penalty was limited to the specific statute. This lack of clarity has produced confusion over the expansiveness of the *Kokesh* holding. If disgorgement is generally considered a penalty, not an equitable remedy, then there is a convincing argument that the courts have exceeded their equitable powers in ordering disgorgement in SEC enforcement actions.

The History of *Kokesh*

In *Kokesh*, the Supreme Court confronted the question of whether disgorgement in a civil enforcement proceeding constituted a penalty subject to 28 U.S.C. § 2462, a five-year statute of limitations applicable to actions seeking a “fine, penalty, or forfeiture.”¹⁴ Before *Kokesh*, the courts consistently held that disgorgement fell within the courts’ equitable relief powers, rendering it free from any limitations period. The Court rejected that approach, holding that § 2462 applies to SEC disgorgement claims because they operate as a “penalty.”¹⁵ The Court reasoned that the disgorgement remedy serves not to compensate victims, but rather as a sanction that is “imposed for the purpose of deterring infractions of public laws,” which “is not a legitimate nonpunitive governmental objective.”¹⁶ Thus, the Court definitively held that disgorgement is a penalty for the purposes of the five-year statute of limitations, and that any SEC action seeking disgorgement outside that window is time-barred.

In an important footnote, however, the Court expressly noted that nothing in the opinion should be interpreted as an opinion on “whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context.”¹⁷ This footnote reflects the skepticism expressed by several Justices during oral argument that such authority even exists.¹⁸ In that single footnote, the Court ostensibly opened up a Pandora’s box, as its intentional refusal to address the issue has led to much litigation in the lower courts.

The Differing Approaches to *Kokesh*

Since *Kokesh*, defendants have challenged the authority of courts to order disgorgement in SEC enforcement actions. Some have argued that the courts have no authority to order disgorgement because

disgorgement is categorically a penalty and thus does not fall under the equitable authority of the courts or under the permitted statutory remedies.¹⁹

Some courts have construed the *Kokesh* decision narrowly.²⁰ For example, a Second Circuit panel recently affirmed a lower district court judgment where the appellant sought to challenge the court's authority to order disgorgement.²¹ The court held that *Kokesh* did not "constitute an intervening decision" where the "precedent on disgorgement in SEC enforcement proceedings is disturbed."²² The court noted that the argument "must therefore await consideration ... en banc or by the Supreme Court."²³

In contrast, other courts have cautioned that *Kokesh* may cast doubt on precedents that grant court authority for disgorgement.²⁴ In a D.C. Circuit concurring opinion, then-Judge Brett Kavanaugh reasoned that "the Supreme Court's decision in *Kokesh* overturned a line of cases from [the D.C. Circuit] that had concluded that disgorgement was remedial and not punitive" and that *Kokesh* was "not limited to the specific statute at issue there."²⁵ Additionally, in the Sixth Circuit, a dissenting opinion noted that "equitable disgorgement' ... may not even be applicable in SEC contexts for much longer in light of" *Kokesh*.²⁶ Yet, it is important to note that no court has conclusively departed from the decades of circuit court precedent that supports the SEC's authority to seek disgorgement. This issue is very much ripe for Supreme Court review.

The Upcoming Case

In *Kokesh v. SEC*, a federal judge granted summary judgment in favor of the SEC against a married couple accused of defrauding millions of dollars from Chinese investors who hoped to immigrate to and obtain permanent residence in the United States.²⁷ The judge ordered the defendants to disgorge the "reasonable approximation of the profits causally connected" to the defendants' violations, which amounted to almost US\$27 million.²⁸

In response to the decision, the defendants appealed, seeking to have the Ninth Circuit overturn the district court's disgorgement order.²⁹ The defendants-appellants argued that the *Kokesh* decision stands for the proposition that the courts lack authority to order disgorgement in SEC enforcement proceedings, as disgorgement is not a form of equitable relief and Congress never authorized such relief.³⁰ However, a Ninth Circuit panel upheld the lower court ruling and noted that *Kokesh* expressly refused to decide that very issue.³¹

The defendants now get another chance at this argument. In their petition to the Supreme Court, they asserted that the issue has been frequently litigated and a decision from the Supreme Court would clarify the law in the absence of statutory authority.³² Furthermore, the defendants-petitioners contended that the current precedent in the lower courts conflicts with the *Kokesh* analysis.³³ Lastly, the defendants-petitioners argued that granting the petition would provide not only the SEC but also other executive agencies with much-needed clarity.³⁴

The Supreme Court May Ultimately Decide Against the SEC

The Supreme Court will finally address whether courts have the authority to order disgorgement in SEC federal court actions. The Court's willingness to address the petition may be a signal that the SEC's long-recognized authority is vulnerable. Indeed, the *Kokesh* footnote — along with repeated comments from a cross-section of Justices at the *Kokesh* oral argument — suggests that the Court is willing to construe the statute's grant of authority that the "Commission may seek, and any Federal court may grant, any equitable relief" narrowly.³⁵

The Court's decision in *Kokesh* suggests the relationship between disgorgement and equitable remedies is tenuous. The Court opined that disgorgement operates as a penalty when the defendant is required to pay a non-compensatory sanction to the government.³⁶ Also, the Court reasoned that disgorgement operates as a penalty when the "primary purpose of disgorgement orders is to deter violations of securities laws."³⁷

In the *Liu* petition, the defendants-petitioners echoed the Court's reasoning in *Kokesh* in arguing for a general classification of disgorgement as a penalty. The petition states that the SEC requested that disgorgement proceeds be given to the SEC, instead of to the alleged victims.³⁸ In addition, the defendants-petitioners argued that the SEC sought a "massive disgorgement" award that "exceeds what the defendant[s] unlawfully gained" to prevent them from future wrongdoing.³⁹ It is entirely possible that the Court holds that the reasoning underlying *Kokesh* necessitates the broad categorization of disgorgement as a penalty. Courts cannot order penalties without express statutory authority. Thus, the Court may find that the SEC lacks authority to obtain disgorgement in federal court actions.

A Decision Against the SEC Would Affect Other Agencies' Access to Disgorgement

The defendants-petitioners argued in their petition that a final decision on the SEC's authority to pursue disgorgement would help establish the limits of power of other agencies. Many other agencies, such as the Federal Trade Commission (FTC)⁴⁰ and the Food and Drug Administration (FDA),⁴¹ continue to seek disgorgement under the courts' authority to order equitable relief, as opposed to under express statutory authority. Indeed, the Seventh Circuit recently departed from other circuits and from its own prior precedent to hold that the FTC cannot seek an award of monetary restitution under its authority to seek injunctive relief.⁴² And there are at least two pending petitions for certiorari asking the Supreme Court to embrace that holding.⁴³ Thus, a decision restricting the SEC's ability to pursue disgorgement would likely restrict disgorgement as an available relief to other agencies.

Conclusion

A Supreme Court decision on this issue has been highly anticipated, as the decision will affect a wide range of actors from lower courts to government agencies to companies that are impacted by securities regulations and operate under regulatory schemes similar to the federal securities laws.

Until the Court decides the issue, the SEC may reconsider its approach when bringing enforcement actions. The agency is likely to consider bringing more cases administratively, an area in which there is express statutory authority for disgorgement, and may more selectively seek disgorgement in the enforcement actions filed in district court. The SEC is also likely to continue pushing for a legislative fix to the issue, like the bills currently under consideration in Congress, which would provide the SEC with authority to seek disgorgement in district court actions.⁴⁴

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Endnotes

¹ *Liu v. SEC*, 2019 U.S. LEXIS 6599, at *1 (2019).

² *Kokesh v. SEC*, 137 S. Ct 1635, 1640 (2017) (citing *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F. 2d 1301 (2d Cir. 1971)).

³ Brief for Petitioner at 3, *Liu v. SEC*, 2019 U.S. LEXIS 6599 (2019) (No. 18-1501).

⁴ *Kokesh v. SEC*, 137 S. Ct at 1640.

⁵ 15 U.S.C. § 77t(b); 15 U.S.C. § 78u(d).

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- ⁶ *Kokesh*, 137 S. Ct at 1640 (citing *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. at 91).
- ⁷ *Id.*
- ⁸ See 15 U.S.C. §§ 77h-1(e), 78u-2(e), 78u-3(e), 80a-9(e) & f(5), and 80b-3(j) & k(5).
- ⁹ When Congress enacted the Sarbanes-Oxley Act of 2002, it enacted statutory language recognizing that courts have the authority to order disgorgement in civil enforcement actions. See Pub. L. No. 107-204, § 308, 116 Stat. 745, 784-85 (2002).
- ¹⁰ Note: Saving Disgorgement from Itself: SEC Enforcement After *Kokesh v. SEC*, 68 Duke L.J. 333, 354.
- ¹¹ See 15 U.S.C. § 77v(a) and 15 U.S.C. § 78aa; see, e.g., *SEC v. Palmisano*, 135 F.3d 860, 865-66 (2d Cir. 1998); *SEC v. Desai*, 145 F. Supp. 3d 329, 337-38 (D.N.J. 2015) ("Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a), and § 27 of the Exchange Act, 15 U.S.C. § 78aa, allow for disgorgement of all profits derived from violating the securities laws.").
- ¹² See 15 U.S.C. § 77t(b) and 15 U.S.C. 78u(d)(1); see, e.g., *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989) ("Disgorgement, then, is available simply because the relevant provisions of the Securities Exchange Act of 1934, sections 21(d) and (e), 15 U.S.C. §§ 78u(d) and (e), vest jurisdiction in the federal courts.").
- ¹³ Hamilton, Joshua G., et. al., [US Supreme Court: Disgorgement Is a Penalty, Limiting SEC's Reach](#), Latham & Watkins *Client Alert* (June 8, 2017).
- ¹⁴ *Kokesh v. SEC*, 137 S. Ct at 1638.
- ¹⁵ *Id.* at 1644.
- ¹⁶ *Id.* at 1643.
- ¹⁷ *Id.* at 1642 n.3.
- ¹⁸ See Oral Arg. Tr. 7-9, 13, 31, 52, *Kokesh v. SEC*, No. 16- 529 (Apr. 18, 2017).
- ¹⁹ See 15 U.S.C. § 77t(b); 15 U.S.C. § 78u(d).
- ²⁰ See, e.g., *SEC v. Sample*, 2017 U.S. Dist. LEXIS 191025, at *4 (N.D. Tex. Nov. 20, 2017) ("*Kokesh* merely held that disgorgement claims are subject to 28 U.S.C. § 2462's five-year statute of limitations. [It] had no effect on how courts apply disgorgement principles."); *FTC v. J. William Enters., LLC*, 283 F. Supp. 3d 1259, 1262 (M.D. Fla. 2017) ("the Supreme Court's deliberate avoidance of [the question of whether disgorgement is permissible] provides no basis for this Court to disregard decades of precedent"); *SEC v. Jammin Java Corp.*, 2017 U.S. Dist. LEXIS 157730, at *8 (C.D. Cal. Sep. 14, 2017) ("As it presently stands, *Kokesh* is best seen as a decision clarifying the statutory scope of § 2462, rather than one redefining the essential attributes of disgorgement.").
- ²¹ *SEC v. De Maison*, 2019 U.S. App. LEXIS 26476, *3 (2d Cir. 2019).
- ²² *Id.* at *3.
- ²³ *Id.* at *3-4.
- ²⁴ See, e.g., *United States v. Latorella*, 2017 U.S. Dist. LEXIS 98849, at *9 n.4 (D. Mass. June 27, 2017) (Woodlock, J.) ("It bears noting that the Supreme Court expressly reserved the question whether courts possess authority to order disgorgement in SEC enforcement proceedings."); *SEC v. Amerindo Inv. Advisors, Inc.*, 2017 U.S. Dist. LEXIS 110407, *29 (S.D.N.Y. July 14, 2017) ("[T]he fact that the Court relied on precedents that might subsequently have been abrogated by the Supreme Court in *Kokesh* is of no moment.").
- ²⁵ *Saad v. SEC*, 873 F.3d 297, 305 (D.C. Cir. 2017).
- ²⁶ *Osborn v. Griffin*, 865 F.3d 417, 470 n.1 (6th Cir. 2017) (Merritt, J., dissenting).
- ²⁷ *SEC v. Liu*, 262 F. Supp. 3d 957, 976 (C.D. Cal. Apr. 20, 2017).
- ²⁸ *Id.*
- ²⁹ *SEC v. Liu*, 754 F. App'x. 505, 509 (9th Cir. 2018), *cert. granted*, 2019 U.S. LEXIS 6599 (2019) (No. 18-1501).
- ³⁰ *Id.*
- ³¹ *Id.*
- ³² Brief for Petitioner at 3, *Liu v. SEC*, 2019 U.S. LEXIS 6599 (2019) (No. 18-1501).
- ³³ *Id.* at 8.
- ³⁴ *Id.* at 19.
- ³⁵ 15 U.S.C. § 78u(d); see Oral Arg. Tr. 7-9, 13, 31, 52, *Kokesh v. SEC*, No. 16- 529 (Apr. 18, 2017).
- ³⁶ *Kokesh v. SEC*, 137 S. Ct at 1644.
- ³⁷ *Id.* at 1643.
- ³⁸ Brief for Petitioner at 12, *Liu v. SEC*, 2019 U.S. LEXIS 6599 (2019) (No. 18-1501).
- ³⁹ *Id.* at 2.
- ⁴⁰ See, e.g., *FTC v. AMG Capital Mgmt., LLC*, 910 F.3d 417, 426-27 (9th Cir. 2018) (holding that the court was bound by prior precedent and that the lower court had the power to order equitable monetary relief under § 13(b) of the Federal Trade Commission Act); *FTC v. Commerce Planet, Inc.*, 815 F.3d 593, 602 (9th Cir. 2016) (holding that a claim under § 13(b) of the Federal Trade Commission Act was equitable).

⁴¹ See, e.g., *United States v. Universal Mgmt. Servs., Inc.*, 191 F.3d 750, 762 (6th Cir. 1999) (holding that nothing in the Federal Food, Drug & Cosmetic Act precludes a court in equity from ordering disgorgement).

⁴² *FTC v. Credit Bureau Ctr., LLC*, 937 F.3d 764, 767 (7th Cir. 2019).

⁴³ See *AMG Capital Mgmt., LLC v. FTC*, No. 19-508 (filed Oct. 18, 2019); *Publishers Bus. Servs., Inc. v. FTC*, No. 19-507 (filed Oct. 18, 2019).

⁴⁴ See Securities Fraud Enforcement and Investor Compensation Act of 2019, S.799, 116th Cong. (2019).