Congressional Research Service
Informing the legislative debate since 1914

Legal Sidebar

Liu v. SEC: The Supreme Court to Consider Whether Disgorgement is an Equitable Remedy in SEC Enforcement Actions

Updated March 5, 2020

Disgorgement is a remedy that requires securities law violators to give up "ill-gotten gains," or gross proceeds, from illegal conduct. In *Liu v. Securities and Exchange Commission*, which was argued on March 3, 2020, the Supreme Court heard argument as to whether federal securities laws authorize federal courts to employ disgorgement as a remedy in SEC enforcement actions. The SEC has long maintained that disgorgement is available to it as an equitable remedy under the Securities Exchange Act of 1934 (Exchange Act), along with its ability to seek civil monetary penalties and other statutory relief. Over the past fifty years, federal courts have frequently awarded disgorgement to the SEC as a remedy for securities law violations. A decision in *Liu* adverse to the SEC may have significant consequences for that agency and others, potentially barring a favored remedy.

This Legal Sidebar examines *Liu* and its implications for the disgorgement remedy in federal agency enforcement actions. First, it discusses the history of disgorgement in SEC enforcement actions and *Liu*'s factual background. Second, it analyzes the historical treatment of the disgorgement remedy and the legal issues surrounding its use.

The Sidebar analyzes some considerations for Congress. In particular, if the Supreme Court limits the SEC's ability to obtain disgorgement in federal court, it could reshape not only the SEC's ability to recover money from wrongdoers, but also the ability of other agencies, such as the Federal Trade Commission (FTC), to do so.

Background

The History of Disgorgement in SEC Enforcement Actions

The Exchange Act established the SEC, but at first gave the agency authority only to seek injunctions barring future securities law violations. Congress has since authorized the SEC to seek "a panoply" of remedies, including civil monetary penalties and "equitable relief that may be appropriate or necessary for the benefit of investors." Equitable relief refers to courts' traditional power to grant remedies that promote fairness and a return to the status quo prior to wrongdoing. And while Congress has authorized the SEC to seek disgorgement in administrative proceedings before SEC administrative law judges, it has never explicitly addressed whether disgorgement is permissible as a form of equitable relief in civil enforcement actions in federal court.

Commentators agree that the U.S. Court of Appeals for the Second Circuit was the first court to opine on the SEC's right to seek disgorgement in civil enforcement actions. In *SEC v. Texas Gulf Sulphur*, decided in 1971, the Second Circuit upheld a district court's decision to require employees of Texas Gulf to disgorge profits obtained through insider trading. The court reasoned that because Section 27 of the Exchange Act granted federal courts general equity powers to remedy securities law violations, it also authorized disgorgement as an ancillary remedy. As one scholar notes, "The general rationale utilized by the SEC and the courts in ordering equitable relief such as disgorgement was that effective enforcement of the federal securities laws required that violations be made unprofitable." In the wake of *Texas Gulf Sulphur*, courts have generally followed that decision, justifying disgorgement on the theory that it is, "by its very nature, an equitable remedy."

However, in *Kokesh v. Securities and Exchange Commission*, decided in 2017, the Supreme Court cast some doubt on whether disgorgement in SEC enforcement actions is equitable in nature. In *Kokesh*, the defendants challenged a $34.9 million disgorgement judgment for the SEC. They argued that disgorgement in this context is a civil penalty and that the five-year statute of limitations applicable to "an action … for the enforcement of any civil fine, penalty, or forfeiture" thus precluded $29.9 million of the judgment that was based on violations that occurred more than five years before the SEC filed its complaint. A unanimous Supreme Court agreed, holding that "[d]isgorgement in the securities-enforcement context is a 'penalty' within the meaning of" the statute of limitations. Writing for the Court, Justice Sotomayor explained that the SEC's use of disgorgement bears "all the hallmarks of a penalty" because it seeks to punish the defendant for a public wrong and to deter others from committing similar offenses, not to compensate individual victims. The Court made clear, however, that its decision was limited solely to the applicability of the statute of limitations, and should not 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." That is the issue now before the Court in *Liu*.

Liu v. SEC

In *Liu*, the SEC sued Charles Liu and his wife, Xin Wang, for violating Section 17(a)(2) of the Securities Act of 1933. Section 17(a)(2) protects investors from fraud in the offer and sale of securities by forbidding any person from making an untrue statement or omission of a material fact. The SEC alleged that Liu and Wang raised over $27 million from foreign investors to build a regional cancer treatment center. But rather than build the center, Liu and Wang fraudulently diverted $26 million for their personal use and to solicit new investors. After finding that Liu and Wang's scheme violated the federal securities laws, a federal district court ordered them to disgorge $26,733,018.81—the total amount of funds they had raised from investors. It also imposed $8.2 million in civil penalties and prohibited them from engaging in similar investment projects.

The Lius appealed the district court's judgment to the U.S. Court of Appeals for the Ninth Circuit. Citing *Kokesh*, Liu argued that disgorgement is not an equitable remedy in the context of SEC enforcement suits. A three-judge panel affirmed the district court's judgment, explaining that Ninth Circuit precedent allowing disgorgement as an equitable remedy barred it from reconsidering the question. The Supreme Court agreed to review the Ninth Circuit's decision on November 1, 2019.

Analysis

Is Disgorgement an Equitable Remedy?

Liu presents the Supreme Court with an opportunity to decide whether disgorgement is an equitable remedy in SEC enforcement actions. However, because authorities have reached different conclusions on the question, it is difficult to anticipate how the Supreme Court might rule on the issue.

For a century and a half after the nation's founding, federal courts performed distinct "law" and "equity" functions using different procedures and granting different relief. The federal judiciary abolished many of the procedural distinctions between "law" and "equity" when it adopted the Federal Rules of Civil Procedure in 1938. But distinctions among remedies persist, and federal courts still classify relief as either legal or equitable. As one scholar has written, "[t]he remedies classified as equitable include injunctions, accounting for profits, constructive trusts, equitable liens, and specific performance," while "[t]he remedies classified as legal include damages, mandamus, habeas, and replevin."

The Supreme Court has stated that a court's equitable jurisdiction extends only to relief "typically available in equity in the days of 'the divided bench' before law and equity merged." To determine whether disgorgement was typically available in courts of equity, the Supreme Court would likely need to turn to historical sources on equitable remedies.

Federal courts, including the Supreme Court, have frequently styled disgorgement as an equitable remedy. As noted above, the Second Circuit in *Texas Gulf* stated that disgorgement was "a proper exercise by the trial judge of the district court's equity powers." In *SEC v. Cavanagh*, the Second Circuit also explained that "chancery courts possessed the power to order equitable disgorgement in the eighteenth century."

Some scholars argue, however, that the SEC's use of disgorgement bears little relation to traditional equitable remedies. In particular, they claim that SEC disgorgement is punitive for the same reasons set forth in *Kokesh*, while, historically, equitable remedies aim only to promote fairness and restore the status quo. The Supreme Court has stated in other contexts that penalties typically fall outside "the well-established rules of equity jurisprudence."

Considerations for Congress

A Supreme Court decision limiting or precluding federal courts' use of disgorgement as an equitable remedy in SEC enforcement actions could have important consequences for the SEC. In Fiscal Year 2019, the SEC obtained court and administrative orders disgorging over $3 billion. As a point of comparison, the SEC obtained monetary penalties totaling $1.101 billion during the same period. As shown by *Liu*, the SEC may recover far more money through disgorgement than by way of monetary penalties in a given case. And as the co-director of the SEC's Division of Enforcement noted in a 2018 speech, the SEC views disgorgement as restitutionary, along with civil monetary penalties, and it often uses disgorged funds to make harmed investors whole.

A former Assistant Director of the SEC's Division of Enforcement suggests that pursuing disgorgement can provide the SEC with "substantial procedural and evidentiary advantages" that do not exist when it seeks civil penalties. These advantages include the ability to try cases before a judge rather than a jury (as is traditional in equity cases), having only to proffer a "reasonable approximation" of funds to be disgorged, and the availability of contempt sanctions carrying jail time as a means to enforce disgorgement orders. Some courts have also held that disgorgement orders do not constitute "debts" under the Federal Debt Collection Procedures Act of 1990 (DCPA), and therefore could fall within any of the DCPA's provisions that allow individuals to exempt certain property from collection by the government.

Other commentators suggest, however, that limiting disgorgement would not materially affect how the SEC brings enforcement actions. They note that the Exchange Act allows courts to impose three tiers of civil money penalties, and each tier permits a penalty totaling "the gross amount of pecuniary gain" and thus "is effectively identical to disgorgement." Commentators also suggest that, if the Supreme Court limits the SEC's right to seek disgorgement, the agency may seek larger penalties to compensate for any curtailment of the remedy, or it may pursue more cases administratively where Congress has expressly granted the agency the right to seek disgorgement.

Liu's implications extend beyond the SEC. One commentator has suggested, for example, that federal agencies that seek disgorgement-like remedies without explicit authorization include the FTC, Food and Drug Administration (FDA), Environmental Protection Agency (EPA), the Federal Energy Regulatory Commission (FERC), the Commodities Futures Trading Commission (CFTC), and the Consumer Finance Protection Bureau (CFPB). If the Supreme Court rules against the SEC in *Liu*, that decision might be deemed by courts to bar or limit the use of disgorgement by these agencies as well as the SEC.

Regardless of *Liu*, Congress is free to enact legislation clarifying its intent regarding the availability of disgorgement in enforcement actions brought by the SEC and other federal agencies. For example, in June 2017, the House of Representatives passed the Investor Protection and Capital Markets Fairness Act, which would amend the Securities Exchange Act to provide for disgorgement. Congress could enact this or similar legislation to make clear that courts may order equitable disgorgement in agency enforcement actions.

Author Information

Joshua T. Lobert
Legislative Attorney

Disclaimer