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What the *Liu* Decision Means for Federal Equity Receivers

By David Slovick

In June, the U.S. Supreme Court issued a decision in *Liu v. Securities and Exchange Commission* which limited the government's ability to impose monetary sanctions on defendants in Securities and Exchange Commission ("SEC") enforcement cases.[1]

Although the decision may not end up having a big impact on individual fraudsters who find themselves litigating against the SEC, *Liu* will be important to entities engaged in legitimate securities business activities that are ordered to return ill-gotten gains made as a result of unlawful conduct. Those defendants can now reduce the total amount of money they are required to pay the government if they can demonstrate that some of the money they raised from investors was used to offset "legitimate expenses" incurred in running their businesses.

For receivers, however, *Liu* will mean more work. Previously, the task of identifying ill-gotten gains that are subject to disgorgement in SEC cases was straightforward—it required only a showing that money left over in a defendant's account after his or her fraud was discovered was directly connected to the defendant's wrongdoing. Now, however, receivers and their counsel will have to perform a detailed analysis to identify which of the money a defendant raised from investors was used for unauthorized purposes and which was used for legitimate business expenses. This, in turn, may mean less money left over for receivers to return to investors at the end of a case.

LEGAL ANALYSIS

The Lower Court Decisions in *Liu*

Liu arose from a fraudulent solicitation scheme related to the federal government's EB-5 Immigrant Investor Program, which allowed non-U.S. citizens to obtain permanent residency in the United States by investing at least $500,000 in a "Targeted Employment Area" and creating at least ten full-time jobs for U.S. workers. Defendant Charles Liu raised $27 million through the program to build and operate a cancer treatment center in California. Instead of building the center, Liu used most of the money to pay himself and his wife millions of dollars in salary, among other unauthorized expenses. In 2016, the SEC sued Liu and his wife for violations of the anti-fraud provisions of the Securities Act of 1933 and Securities Exchange Act of 1934.[2]

The district court granted summary judgment in favor of the SEC and ordered the Lius to disgorge (give back) the ill-gotten gains they made from their fraud. Although the Lius did not dispute their obligation to pay disgorgement, they did dispute the *amount* of disgorgement they owed. The correct measure of disgorgement, they argued, was the total amount of money raised from investors

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less the amount of investor money left at the time the SEC shut down the fraud, *and* less the amount of the defendants' "legitimate business expenses."[3] The district court rejected this method of calculation, however, on the grounds 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."[4]

On appeal to the Ninth Circuit, the defendants argued that 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.[5] 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.[6] Relying on the Supreme Court's 2017 decision in *Kokesh v. Securities and Exchange Commission*, which also dealt with the reach of the SEC's disgorgement authority, the defendants argued 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.[7] By refusing to exempt their legitimate business expenses from the total disgorgement award, defendants believed the court ignored the well-settled definition of disgorgement as "a reasonable approximation of *profits* causally connected to the violation."[8]

The Ninth Circuit disagreed, 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."[9] The court also rejected the defendants' claim that the district court lacked authority to impose disgorgement at all insofar as disgorgement served as a penalty rather than an equitable remedy. The Supreme Court had raised the same issue in *Kokesh*, but only to clarify that the *Kokesh* decision was not meant to express an opinion about the scope of courts' authority to order disgorgement in SEC enforcement cases.[10]

The Supreme Court's Decision in *Liu*

The Supreme Court began its analysis of the disgorgement question in *Liu* with a look back to its earlier decision in *Kokesh*. According to the majority, the Court's limited task was to answer the "antecedent question" it had "reserved" for itself in *Kokesh*:

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"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.[11] The Court's holding was therefore also limited: a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is permissible under Section 21(d)(5).[12]

To reach this conclusion, the Court first sought to determine whether, as a historical matter, equitable disgorgement was among the forms of relief "that were typically available in equity."[13] The court decided that disgorgement was recognized historically by courts sitting in equity, 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.[14]

Despite this history, the SEC argued that the common law understanding of disgorgement was not relevant to the court's interpretation of the equitable remedies contemplated by Section 21(d)(5) because it is a statutory provision, not an outgrowth of common law. By codifying its equitable authority in Section 21(d)(5), the SEC said Congress intended the SEC's disgorgement authority to go beyond the limits imposed by the common law.[15] The Court rejected this view and instead determined that longstanding equitable principles were incorporated into Section 21(d)(5). As a result, Congress prohibited the SEC from seeking an equitable remedy in excess of a defendant's net profits from wrongdoing when it enacted that provision.[16]

But although the Court defined the general contours of the SEC's disgorgement authority, it declined to rule on how that authority applied to the particular facts *Liu* presented. The Court stopped short of deciding whether the petitioners' "disgorgement award [was] unlawful because it fail[ed] to return funds to victims" of petitioners' fraud, or because it did not "deduct business expenses from the award," 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."[17] It thus remanded the specific issues surrounding the disgorgement calculation to lower courts.

***Liu*'s Impact in SEC Enforcement Actions**

Because it limited the SEC's ability to collect disgorgement in its enforcement actions, *Liu* must be considered a victory for the defense bar and a loss for the SEC. Before *Liu*, courts typically refused to allow defendants in SEC cases to reduce the amount they were ordered to pay in disgorgement to account for expenses they incurred in running the businesses that gave rise to the underlying enforcement actions. As a result, the SEC's enforcement staff did not spend much time worrying about whether the amount of disgorgement they sought excluded the legitimate costs of running the defendant's business. That is not, however, a criticism of the SEC. The standard for determining the amount of money properly subject to a disgorgement order has always been permissive: "courts have held that a party seeking disgorgement need only provide 'a reasonable approximation of profits causally connected to the violation.'"[18]

After *Liu*, however, the SEC will have to make a greater effort to determine whether money raised from investors was spent on costs necessary to run a legitimate business rather than misappropriated or otherwise spent in ways that shareholders did not authorize. Receivers will likely bear a lot of this burden: much of the spadework necessary to determine which specific income streams were spent on legitimate business expenses and which were spent on wholly unauthorized expenses will, consistent with their remit, fall to receivers.

For defendants, the decision in *Liu* is a positive development because legitimate businesses will always spend a portion of investors' money on completely lawful expenses. According to *Liu*, these expenses must now be excluded from SEC disgorgement awards. And while the Supreme Court did not offer a specific rule to help litigants determine which of the defendants' expenses are included in the "net profits" that are properly subject to disgorgement, it provided some guidance:

> It is true that when the entire profit of a business or undertaking results from the wrongdoing, a defendant may be denied "inequitable deductions" such as for personal services. . . . But that exception requires ascertaining whether expenses are legitimate or whether they are merely wrongful gains under another name. . . . Doing so will ensure that any disgorgement award falls within the limits of equity practice while preventing defendants from profiting from their own wrong.[19]

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In practical terms, this guidance amounts to an invitation for defendants to scrutinize each element of the SEC's disgorgement calculation to ensure that it comports with the Court's "net profits" rule. The majority of entities targeted by the SEC for enforcement action are not wholly fraudulent concerns; they are legitimate businesses that have violated the securities laws in some discrete area of the firm's operations. After *Liu*, the costs necessary to fund the legal segments of a defendant's business must be distinguished from money used to fund unlawful conduct, and backed out of the SEC's disgorgement calculation.

Finally, the Court's guidance in *Liu* provides another way for defendants to push back on SEC disgorgement demands. The Court in *Liu* suggested that disgorgement collected by the SEC but not returned to investors (because they cannot be found, or because there are no identifiable victims of the defendant's fraud) may not qualify as legitimate equitable disgorgement at all. This is because Section 21(d)(5), which authorizes the SEC to seek equitable remedies in district court cases, also requires that such remedies be "appropriate or necessary for the benefit of investors." This wrinkle, too, will likely add to receivers' responsibilities because they will be called upon to help identify specific investors who were harmed by the defendant's conduct, and to assist the SEC in tracking down investors to whom disgorgement will be paid. Alternatively, if there are no discernible investors to whom money can be returned, the SEC may well be foreclosed by the language of Section 21(d)(5) from seeking disgorgement in any amount—thus eliminating one of a receiver's primary tasks of returning ill-gotten money to its rightful owners.

Addendum from the Author

On January 1, 2021, Congress voted to confirm the SEC's authority to obtain disgorgement for violations of the federal securities laws when it passed the National Defense Authorization Act for Fiscal Year 2021 ("NDAA"). Among other changes to the federal securities laws, the NDAA amends the Securities Exchange Act of 1934 by codifying the SEC's authority to seek disgorgement from persons who receive unjust enrichment. But while the new legislation formalizes certain aspects of the SEC's disgorgement authority, it does not override the central holding of Liu v. SEC. Legitimate business expenses still must be deducted from the SEC's disgorgement awards, leaving receivers' obligation to parse defendants' use of customer money largely unchanged.

ENDNOTES

1. No. 18-1501, 2020 WL 3405845 (June 22, 2020).
2. *Sec. and Exch. Comm'n v. Liu*, 262 F. Supp.3d 957, 960-63, 970 (C.D. Cal. 2017).
3. *Id*. at 975 (internal quotation marks omitted).
4. *Id*. (quoting *Sec. and Exch. Comm'n v. JT Wallenbrock & Assocs.*, 440 F.3d 1109, 1113 (9th Cir. 2006) (internal quotation marks omitted)).
5. Brief for Defendants-Appellants, *Sec. and Exch. Comm'n v. Liu*, No. 17-55849, 2017 WL 6611910, at *49 (9th Cir. Dec. 21, 2017).
6. *Sec. and Exch. Comm'n v. Liu*, 754 F. App'x. 505, 509 (9th Cir. 2018).
7. *Id*.; *see also* Brief for Defendants-Appellants, 2017 WL 6611910, at *50.
8. Brief for Defendants-Appellants, 2017 WL 6611910, at *51 (quoting *JT Wallenbrock & Assocs.*, 440 F.3d at 1113-14 (internal quotation marks omitted, emphasis added)).
9. *Liu*, 754 F. App'x. at 509.
10. *Kokesh v. Sec. and Exch. Comm'n*, 137 S. Ct. 1635, 1642 n.3 (2017).
11. *Liu*, 2020 WL 3405845, at *2.
12. *Id*.
13. *Id*. at *5 (internal citations, quotation marks, and emphasis omitted).
14. *Id*. at *5, *8.
15. *Id*. at *8.
16. *Id*. The lone dissenter in *Liu*, Justice Thomas, disagreed with both the premise and the substance of the majority's decision. In his view, disgorgement awards are never appropriate under Section 21(d)(5) because that provision authorizes the SEC to seek only "equitable relief that may be appropriate or necessary for the benefit of investors," and disgorgement is not a traditional equitable remedy.
17. *Id*. at *9.
18. *Sec. and Exch. Comm'n v. Lek Sec. Corp.*, No. 17cv1789 (DLC), 2020 WL 1316911, at *3 (S.D.N.Y. Mar. 20, 2020) (internal citations omitted).
19. *Liu*, 2020 WL 3405845, at *11-12 (internal citations and quotation marks omitted).