NEW ENGLAND LEGAL FOUNDATION

ADVANCE SHEET

June 2020

ENDING AN UNLAWFUL FIFTY-YEAR PRACTICE BY LOWER FEDERAL COURTS, THE UNITED STATES SUPREME COURT AGREES WITH NELF THAT IN AN SEC ENFORCEMENT ACTION FEDERAL COURTS LACK EQUITABLE POWER TO IMPOSE "DISGORGEMENT" AS A PENALTY FOR VIOLATION OF SECURITES LAWS.

***Liu v. Securities and Exchange Commission*, __ U.S. __, 2020 WL 3405845 (June 22, 2020)**

This case involved the question of whether a major federal agency has long been obtaining certain kinds of court-ordered monetary relief from private parties unlawfully. For decades the Securities and Exchange Commission has invoked the equitable powers of federal courts in order to obtain judgments for the so-called "disgorgement" of funds allegedly acquired in violation of federal securities laws. The origins of this practice date back to a 1970 federal district court decision, and the amounts won by the commission in disgorgements now total billions of dollars annually.

Surprisingly, then, in 2017, when the Supreme Court was considering what limitations period applies to such suits, five of the justices wondered aloud during oral argument as to where exactly the SEC was authorized by statute to sue for this remedy. For example:

> Justice Kennedy: Is it clear that the district court has statutory authority to do this? . . . [I]s there specific statutory authority that makes it clear that the district court can entertain this remedy?
>
> . . . .
>
> Justice Sotomayor: Can we go back to the authority? . . . [I]f they're not doing restitution, how could that be the basis of disgorgement?

After deciding that the such disgorgements are a penalty and so fall within a statute of limitations applicable to penalties, the justices pointedly left it an open question whether courts may order them. Hence, the lawfulness of these "disgorgement" awards became a pressing legal question not only for defendants in SEC suits, but also for anyone who shares NELF's view that federal courts and agencies should exercise solely those powers that they legitimately possess.

This case presented the question squarely. The SEC sued the petitioners, alleging that they had misappropriated funds as part of a sham investment scheme. The federal district court granted the SEC summary judgment, enjoining the petitioners from participating in investment schemes in the future and imposing on them civil monetary penalties allowed under securities statutes. The court also relied on its equitable powers to order petitioners to disgorge over $26 million. Notably, the SEC did not ask that those funds be distributed as restitution to the defrauded investors, and there exists no statute requiring that they be used for that purpose.

The petitioners, having lost their appeal to the Ninth Circuit, petitioned the Supreme Court for certiorari. The Supreme Court granted cert, and merits briefing followed. The petitioners argued that since the Court decided in 2017 that such disgorgements are penalties, the federal court was without equitable jurisdiction to order disgorgement because equity may not impose penalties.

In support of the petitioners, NELF filed an amicus brief in which it noted that at the time of the American Revolution nothing in English Courts of Chancery resembled the punitive disgorgements

obtained by the SEC over the past fifty years. Among other historical corroboration, NELF showed that 18th century law dictionaries contained no entries for either "disgorge" or "disgorgement."

NELF then examined *Kokesh v. Securities and Exchange Commission*, 137 S.Ct. 1635 (2017), the case in which five justices had voiced concerns about the lawfulness of disgorgements. The SEC contended that although *Kokesh* held the securities disgorgements at issue there to be penalties, the holding was limited to limitations of action. NELF responded that the three factors the Court found decisive on the penalty question exist independently of the law of limitations of actions; while those factors were applied to answering the limitations question, they did not arise out of that context and in fact they exist in this case too. Principal among those factors is that the disgorged funds typically are not used to make restitution to injured parties but are kept by the government. The *Kokesh* Court's ruling equally applies here, NELF concluded.

NELF next turned to the SEC's use of other federal case law. NELF showed that cases cited by the SEC, even when they may use the word "disgorgement," awarded relief that was in fact restitution given to the injured parties in order to restore them to the status quo ante. In *Porter v. Warner Holding Co.*, 328 U.S. 395 (1946), a case which is pretty much the *locus classicus* for an enlarged view of equitable powers, the money "disgorged" was returned to the injured parties from whom it had been taken wrongfully and so the "disgorgement" did not serve a punitive purpose, a point the *Porter* court itself made expressly.

NELF also explained why the canon of prior construction does not apply. This canon applies when specific words of a statute have received authoritative interpretation by courts and a later reenactment retains those words; the words are then deemed to bear the prior construction. SEC argued that a string of Supreme Court cases favorable to its view of equitable powers formed a background to Congress's passage of Sarbanes-Oxley, which supposedly in effect ratified that view. NELF objected that none of the elements of the canon was satisfied. SEC failed to identify both which specific words of a particular securities statute had received an earlier authoritative interpretation by the Court and how Sarbanes-Oxley had re-enacted those specific words, thereby ratifying the prior interpretation given them by the Court. NELF then examined the cases cited by the SEC in this connection, and found that the cases fail to show that, before the enactment of Sarbanes-Oxley in 2002, the Court had reached a clear, settled view that *punitive* disgorgement, like that described in *Kokesh*, is relief available under the equitable powers of a federal court. Those cases merely show that the Court sometimes used the word "disgorgement" in a *non-punitive* sense, as a synonym for restitution made to injured parties to put them back into the status quo ante, unlike here.

In an 8-1 decision, issued on June 22, 2020, the Court held that "disgorgements," to be equitable, must be limited to stripping a wrongdoer of unlawful gains in order to return them to his victims. The relief must be restitutionary and aim to restore the status quo ante, as NELF had pointed out was the historical practice of the Court itself. The Court vacated the judgment and remanded for consideration of some issues of liability and relief arising from the particular facts of the case.

If you would like more information about this case or a copy of NELF's amicus brief please email us at info@nelfonline.org.