Disgorgement in EB-5 Cases:

Wrongdoers Should Not Profit from Their Wrongs

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In June 2020, the U.S. Supreme Court issued a landmark securities enforcement decision when it upheld the Securities and Exchange Commission's ("SEC") authority to obtain disgorgement for ill-gotten gains in federal court actions. The Supreme Court's decision is noteworthy in the context of the EB-5 Program because the underlying case that served as the basis for the appeal involved securities laws violations perpetrated by a couple that raised EB-5 funds from Chinese investors.[1] The ruling, of course, will also apply to all future enforcement actions sought by the SEC in federal court.

Importantly, however, the Court's recent decision in *Liu v. SEC*[2] did not address the substance of the securities laws violations themselves, which were nothing if not textbook examples of garden variety fraud that could arise in any securities offering. In fact, the Court agreed that defendants Charles C. Liu and his wife Xin Wang committed securities fraud by misappropriating funds and must pay civil penalties for that fraud. Instead, *Liu v. SEC* presented the Court with narrower issues of whether the SEC had the statutory authority to seek and obtain disgorgements in federal court and under which circumstances the SEC may obtain such relief. In rendering its decision, the Court upheld the SEC's authority to seek disgorgement as equitable relief in securities laws enforcement actions but clearly reasoned that disgorgement awards must not exceed a wrongdoer's net profits.[3]

Consequently, the SEC recently filed in California district court asking the court to make the defendants Liu, Wang, and their associated companies pay just under $20.9 million in disgorgement plus nearly $71,000 in prejudgment interest.

This article aims to discuss the historical context for SEC disgorgement awards, provide a procedural backdrop for *Liu*, and address the potential impact on securities laws violations in the context of the EB-5 Program.

Disgorgement Authority under Kokesh v. SEC

As a threshold matter, it is critical to distinguish between the SEC's authority in an administrative law setting versus the authority granted to it under federal securities laws. The SEC has express statutory authority to obtain disgorgement in enforcement proceedings it brings before administrative law judges.[4] However, the federal securities laws, including the SEC's authorizing statutes, did not expressly enumerate disgorgement as an available remedy in federal actions at the time *Liu* was decided.[5] Rather, federal securities laws instead provide that the SEC may ask courts for "any equitable relief that may be appropriate or necessary for the benefit of investors."[6]

Of course, the SEC has successfully sought and obtained disgorgement as a form of "equitable relief" without significant scrutiny for nearly 50 years until 2017, when the U.S. Supreme Court heard *Kokesh v. SEC*.[7] In *Kokesh*, the Court determined that the SEC primarily used disgorgement to redress public wrongs and generally deter securities laws violations, and imposed a meaningful hurdle on the SEC by reasoning that disgorgement was a "penalty" subject to a five-year statute of limitations.

Though the Court's opinion mentioned in a footnote that the Court was not passing judgment on "whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context," to some the Court's ruling in *Kokesh* was interpreted as a willingness to at least consider the issue of the SEC's disgorgement authority. Perhaps it was the specter that led the SEC to announce in its 2019 annual report that the Court's decision in *Kokesh* adversely impacted the SEC's ability to disgorge long-running frauds and estimated that *Kokesh* forced the SEC to forgo approximately $1.1 billion dollars in disgorgement.[8]

SEC v. Liu: A History

Following *Kokesh*, the SEC's disgorgement authority remained largely unsettled until *SEC v. Liu*, a 2017 California district court case that became widely known to EB-5 practitioners. There, the SEC charged Charles Liu and Xin

1 See SEC v. Liu, 262 F. Supp. 3d 957 (C.D. Cal. 2017).

2 140 S. Ct. 1936 (2020).

3 Of course, the SEC will still retain the authority to seek other penalties for wrongdoers, such as punitive damages.

4 15 U.S.C. § 78u-2(e).

5 On January 1, 2021, Congress amended Section 21(d) of the Securities and Exchange Act of 1934 to expressly authorize the SEC to obtain disgorgement in civil actions.

6 See 15 U.S.C. § 78u(d)(5).

7 137 S.Ct. 1635 (2017).

8 https://www.sec.gov/files/enforcement-annual-report-2019.pdf.

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(Lisa) Wang with defrauding Chinese investors in connection with the development and operation a proton therapy cancer treatment center to be located in Southern California. In its case, the SEC alleged that the defendants had raised approximately $27 million from fifty investors in order to finance the cancer center, but had deliberately defrauded investors with the illusion of progress while misappropriating funds by diverting them to overseas marketers and paying themselves exorbitant salaries.

In its 2017 decision, the U.S. District Court for the Central District of California held that Liu and Wang had violated federal securities laws and ordered the couple to pay approximately $8.2 million in civil penalties and approximately $26.7 million in disgorgement. In response, the defendants argued that the disgorgement award should be offset by purported business expenses. On appeal, the U.S. Court of Appeals for the Ninth Circuit upheld the District Court's award by holding 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."[9]

By November 2019, the U.S. Supreme Court agreed to hear the defendants' case. In briefing, the couple argued that the omission of "disgorgement" from the statute enumerating the SEC's judicial remedies was intentional since Congress expressly authorized the SEC to obtain disgorgement in administrative proceedings (and presumably could have codified such remedy in federal securities laws as well). The SEC rebutted the defendants' argument by stating that the SEC's authorizing statute impliedly granted it the authority to seek disgorgement under the general umbrella of "equitable relief." Moreover, the SEC offered precedent from numerous lower court decisions that widely held that courts could award the SEC disgorgement as an equitable remedy ancillary to an injunction.

In June 2020, the Court sided with the SEC by holding that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under §78u(d)(5)."[10]

Importantly, the Court was unpersuaded by the fact that Congress used the term "disgorgement" when defining the SEC's administrative remedies but not when defining its judicial remedies, noting that "it makes sense that Congress would expressly name the equitable powers it grants to an agency for use in administrative proceedings," because agencies, unlike courts, lack "inherent equitable powers."[11] The Court further noted the usage of various terms that are often synonymous with disgorgement – including restitution – that have long authorized courts to strip wrongdoers of their ill-gotten gains.[12] These remedies, by whatever name or label, underscore a core tenet of equity, namely that a wrongdoer should not profit from his own wrong.[13]

Of course, the Court also understood that decisions made in equity are also inherently limited by the countervailing principle, namely that the wrongdoer should not be punished by "pay[ing] more than a fair compensation to the person wronged."[14] Accordingly, the Court's central holding was that equity courts should limit disgorgement to net profits from wrongdoing and must deduct legitimate business expenses before calculating and ordering disgorgement. As a result, *Liu* was remanded to the Central District Court in California for a determination of the amount of disgorgement.

In its recent April 2021 filing, the SEC argued that the defendants are only entitled to deduct from the disgorgement award amounts they spent in accordance with the offering documents to establish the proton therapy center and listed several illegitimate expenses that Liu and Wang "incurred solely to fuel their fraudulent scheme" that should not be deducted from disgorgement. Among these illegitimate fees were $3 million paid to an equipment supplier and salaries that Liu and Wang paid to themselves in the amounts of $6.7 million and $1.5 million, respectively.

Impact of Liu Decision on EB-5 Enforcement Actions and Beyond

The impact of *Liu* is not so much an issue of whether the SEC may obtain disgorgement but under what circumstances it may obtain such relief. Going forward, the SEC will be required to deduct "legitimate" expenses from disgorgement amounts. Additionally, the Court's holding in *Liu* would also require disgorgement proceeds to be distributed to defrauded investors (to the extent feasible). Although only time will tell, the SEC could perhaps seek higher civil monetary penalties in judicial actions to counteract what it may perceive as a limitation on its authority to seek full disgorgement of all ill-gotten gains. After all, the SEC has broad flexibility under the federal securities laws to determine civil penalties in each case and, as such, could seek civil penalties in the amount of a defendant's illicit gain.

It would also be possible for the SEC to instead seek enforcement actions as administrative proceedings, where disgorgement awards may face less scrutiny and are less susceptible to be challenged. However, as the Court's opinion in *Liu* suggests, disgorgement in administrative proceedings would likely be subject to challenge to the extent it fails to abide by the equitable principles articulated in *Liu*,[15] such as the failure to deduct legitimate business expenses. Nonetheless, as the SEC argued on remand, general ledgers that document seemingly legitimate expenses are not in and of themselves probative so as to be excluded from disgorgement as a matter of right.

As such, disgorgement may not be avoided simply because the accounting ledgers detailed the expenses projected to be incurred and paid using EB-5 funds. Rather, once the SEC has established its reasonable calculation, the burden would shift to the defendant to prove the expenses were legitimate and indeed contemplated in the EB-5 project's offering documents. As always, the "sources and uses" of funds is at the crux of securities disclosure and is the core of the investment decision. What remains to be determined on remand are what types of business expenses would be deemed legitimate and reasonable, including EB-5 project development and operational expenses not disclosed in the offering materials, offering and other legal fees and expenses, fees paid to overseas migration agents and salaries and/or management fees paid to principals. Nevertheless, the SEC has already argued on remand that disgorgement in *Liu* would be proper based on the equitable principles handed down by the Court since the defrauded EB-5 investors, and the amounts of their investments, are clearly identifiable. Accordingly, should the SEC successfully obtain disgorgement from defendants Liu and Wang, the SEC would be in a position to disburse the disgorged funds to the aggrieved EB-5 investors as equitable relief for the securities laws violations committed by the defendants.

9 SEC v. Liu, 754 F. App'x 505, 509 (9th Cir. 2018) (quoting SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1114 (9th Cir. 2006)).
10 Liu v. SEC, 591 U. S. ____, Slip Op. at 1.
11 Id. at 13.
12 Id. at 6.
13 Id. (quoting Root v. Railway Co., 105 U. S. 189, 207 (1882)).
14 Id. at 7 (quoting Tilghman v. Proctor, 125 U. S. 136, 145–146 (1888)).
15 Note, in Liu, the Court also held that disgorgement would only be proper where it is appropriate or necessary for the benefit of investors, which would seemingly cast doubt on the SEC's authority to collect disgorgement in circumstances where disgorged proceeds would be deposited in the Treasury rather than returned to investors.