

Second Circuit Reins in SEC Disgorgement Powers

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In [*Securities & Exchange Commission v. Govil*](#), No. 22-1658, 2023 WL 7137291 (2d Cir. Oct. 31, 2023), the [United States Court of Appeals for the Second Circuit](#) dealt a setback to the enforcement agenda of the [Securities and Exchange Commission](#) (“SEC”) by limiting its ability to seek disgorgement under [15 U.S.C. § 78u\(d\)\(5\) and \(7\)](#) to situations in which the regulator can demonstrate investors have suffered pecuniary harm.

In *Govil*, the SEC alleged that the defendant caused his former company, Cemtrex, to issue securities under false pretenses, assuring investors that their \$7.3 million in funds would go towards business expenses when, in reality, they were used to pay defendant’s personal expenses and finance other business ventures. Defendant entered into a settlement with Cemtrex whereby he surrendered all of his securities in the Company, which the parties agreed were worth about \$5.6 million, and paid the company an additional \$1.5 million in the form of a secured promissory note.

Defendant also entered into an April 2021 Consent Agreement with the SEC through which he consented to entry of judgment of all counts of securities fraud and the entry of injunctions and fines, but

left open the issue of disgorgement. In July 2021, the SEC filed a civil action against defendant in the [United States District Court for the Southern District of New York](#) and moved for disgorgement pursuant to 15 U.S.C. § 78u(d)(5) and (7). The district court ordered defendant to pay approximately \$5.8 million in disgorgement — the total amount requested by the SEC less the face value of the promissory note. Defendant appealed, arguing, among other things, that disgorgement was unavailable to the SEC under the [United States Supreme Court](#)'s decision in [Liu v. SEC](#), 140 S. Ct. 1936 (2020) (blog article [here](#)), as the regulator failed to show there were any victims for whom disgorgement may be awarded.

The Second Circuit agreed. The Court recounted the history of 15 U.S.C. § 78u(d)(5) and (7) from which the SEC derives its authority to seek disgorgement. The former is the statutory provision pursuant to which the regulator historically sought disgorgement as a form of “equitable relief that may be appropriate or necessary for the benefit of investors.” However, in June 2020, the Supreme Court in *Liu* held that disgorgement may only be ordered in a manner consistent with several equitable principles, including that it must be “awarded for victims.” Seven months later, Congress passed the [William M. \(Mac\) Thornberry National Defense Authorization Act for Fiscal Year 2021](#) (the “NDAA”), which contained several provisions relating to disgorgement. Among them, the new 15 U.S.C. § 78u(d)(7) established that the SEC “may seek, and any Federal court may order, disgorgement.” Practitioners and financial professionals questioned whether this new provision, referencing disgorgement but without language requiring that it be “appropriate or necessary for investors,” superseded *Liu* and freed the SEC from the High Court’s equitable constraints, or instead codified the SEC’s ability to seek disgorgement subject to those limitations.

Other federal circuit courts have begun to tackle this question. On July 19, 2022, in [*SEC v. Hallam*](#), 43 F.4th 316 (5th Cir. 2022), the Fifth Circuit held that 15 U.S.C. § 78u(d)(7) “authorizes disgorgement in a legal — not equitable — sense” (*id.* at 334-35), meaning that disgorgement under 15 U.S.C. § 78u(d)(7) is not limited by the equitable principles recognized in *Liu* but follows the standards the federal courts developed before *Liu*. Nearly a year later, in [*SEC v. Ahmed*](#), 72 F.4th 379 (2d Cir. 2023), the Second Circuit disagreed, holding that 15 U.S.C. § 78u(d)(7)’s use of the word disgorgement refers to a “remedy grounded in equity” and so must “be deemed to contain the limitations upon its availability that equity typically imposes,” including that it be awarded for victims. *Id.* at 396 (quoting *Liu*, 140 S. Ct. at 1947).

With its decision in *Govil*, the Second Circuit has “doubled down” on its opposition to the Fifth Circuit, holding that the “victims” for whom disgorgement may be awarded under *Liu* are only those that have suffered pecuniary harm. The Court reasoned that defining victim to include those who suffered no pecuniary harm and thus allowing such investors to receive the proceeds of disgorgement would not be restoring the status quo, but “conferring a windfall on those who received the benefit of the bargain.” *Govil*, 2023 WL 7137291 at *9.

The *Govil* Court went on to explain it was not sufficient, as the SEC argued, that investors were told a lie and thus denied the right to make an informed decision when considering whether to make the investment. “[T]he right to make informed decisions about the dispositions of one’s assets does not result in pecuniary harm.” *Id.* at *11. “In sum, § 78u(d)(5) and § 78u(d)(7) authorize disgorgement that is ‘equitable relief.’ ‘Equitable relief’ requires that the relief be ‘awarded for victims,’ and that in turn requires a finding of pecuniary harm.” *Id.* at *12 (internal citations omitted).

The Second Circuit held that because the district court found the investors were victims without determining whether those investors suffered pecuniary harm, it based its ruling on an erroneous view of the law and thereby abused its discretion. The Court vacated the district court's judgment and remanded with instructions that it make that factual determination. If it concludes that investors suffered pecuniary harm, the Second Circuit further ordered the district court to offset the value of defendant's surrendered securities against the overall disgorgement award.

Nearly three years after passage of the NDAA, defendants in SEC enforcement actions find themselves in much the same position wondering whether and under what conditions the SEC may pursue profits from an allegedly unlawful enterprise. While the Second Circuit's decision in *Govil* lends significant credibility to the argument that *Liu*'s equitable constraints on disgorgement survived passage of the NDAA, it remains to be seen whether the Supreme Court will be called upon to resolve a deepening circuit split on the issue should Congress remain silent.

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