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Second Circuit Limits SEC Disgorgement – Decision Puts Remedy in Question in Wide Range of Cases

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The decision could effectively blunt the SEC's ability to seek disgorgement for a wide range of alleged regulatory violations that do not result in financial harm to any investors.

In a case with potentially far-reaching implications for the SEC's enforcement program, the Second Circuit recently held that the SEC is not entitled to disgorgement unless it can show the allegedly defrauded investors suffered pecuniary harm. The case, *Securities and Exchange Commission v. Govil*,[1] provides important limitations on the SEC's ability to seek disgorgement, especially in circumstances where the allegedly violative conduct does not result in obvious "victims." The case provides defense counsel with persuasive authority to oppose an SEC claim for disgorgement absent proof of any harm to investors especially if all the SEC alleges is a benefit to the defendant. The decision could effectively blunt the SEC's ability to seek disgorgement for a wide range of alleged regulatory violations that do not result in financial harm to any investors. **Factual Background** Aron Govil founded and served as CEO of Cemtrex, Inc., an industrial and manufacturing technology company. In 2016 and 2017 Govil caused Cemtrex to issue new securities based on misrepresentations concerning the expected use of the funds that were raised, which Govil then transferred to his own accounts to pay for unrelated personal expenses. After he was caught, Govil entered into a settlement agreement with Cemtrex, which he no longer ran, and agreed to repay $7.1 million to the company by returning $5.6 million of Cemtrex securities and issuing a promissory note for $1.5 million. In addition, Govil also entered into a consent agreement with the SEC in which he agreed not to contest a civil enforcement action that would be brought by the SEC but which left the remedy unresolved. After bringing an enforcement action, the Commission asked the district court to order disgorgement of approximately $7.3 million.[2] The district court did so over Govil's objections, concluding that disgorgement was appropriate because Cemtrex's defrauded investors were Govil's "real victims" rather than Cemtrex itself, and that the $5.6 million in securities that Govil returned to Cemtrex would not offset what he owed as "Cemtrex shareholders received nothing" from that transfer.[3] Critically, however, the SEC offered no proof—and the district court made no findings—that Cemtrex's shareholders suffered any pecuniary harm resulting from Govil's fraud. Govil was ordered to disgorge approximately $6 million, from which he appealed. **The Second Circuit's Decision** On appeal, the Second Circuit vacated the relief ordered by the district court and remanded the matter for further fact-finding. Applying the Supreme Court's teachings in *Liu* that disgorgement "is permissible" as equitable relief only where it "is awarded for victims,"[4] the Second Circuit held that disgorgement under both 15 U.S. §§ 78u(d)(5) and 78u(d)(7) requires a finding that there were victims who suffered some financial loss. Noting that *Liu* "did not explain straightforwardly what a 'victim' is for the purpose of awarding 'equitable relief,'" the Second Circuit held that "a 'victim'" is "one who suffers pecuniary harm from the securities fraud" because allowing disgorgement to benefit investors who had not suffered any damages "would be conferring a windfall on those who received the benefit of the[ir] bargain" rather than "restoring the status quo for those investors."[5] In doing so, the Court expressly rejected a presumption that investors have "suffered economic harm by definition when capital they invested in the company for corporate purposes [is] looted," explaining that determining whether investors "actually suffered pecuniary harm" requires an analysis of "the type of securities held, the terms of

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those securities, and when those securities were sold" because defrauded investors might earn a profit on their investment notwithstanding a defendant's wrongdoing.[6] As the Second Circuit reasoned, *Liu* "emphasized" that disgorgement as "an equitable remedy is about 'returning the funds to victims,'" which necessarily "presupposes pecuniary harm" as funds "cannot be returned if there was no deprivation in the first place."[7] In reaching this conclusion, the Second Circuit also drew an important analogy between SEC enforcement actions and securities fraud actions brought by private plaintiffs. Although the SEC need not show loss causation or economic loss to prevail in litigation, the Court noted that private plaintiffs bringing securities fraud claims under Rule 10b-5 must prove that they "have suffered 'economic loss'" and, similarly, that "pecuniary harm is an element" of common-law fraud claims.[8] Accordingly, the Court rejected the notion that investors who have not been shown to have suffered pecuniary harm should be allowed to receive "proceeds of disgorgement," which otherwise "would allow the SEC to . . . circumvent the limitations on private claims under § 10(b) and the common law."[9] Because there was no showing that Govil had caused any such pecuniary harm to Cemtrex's investors, that relief was vacated to allow the district court to determine in the first instance if there was any such harm, a necessary prerequisite for disgorgement to be available. In addition, the Second Circuit also held that the district court erred in not offsetting its disgorgement award by the value of the Cemtrex shares surrendered by Govil. Rejecting the SEC's arguments, the Second Circuit reasoned that "a wrongdoer returns 'value' for the purpose of disgorgement whenever he returns property that holds value in his own hands" and that "a defendant need not return more than the amount by which he was unjustly enriched" because disgorgement is intended "'to prevent wrongdoers from unjustly enriching themselves'" rather than "'to compensate victims.'"[10] **Implications of *Govil*** Going forward, by limiting disgorgement and more closely aligning it with the relief available in private securities fraud actions in which economic loss and loss causation must be proven, the SEC will be forced to more clearly identify and prove the harm suffered by alleged "victims" in many of its enforcement actions. Although this analysis is relatively straightforward in more traditional securities fraud cases, *Govil* will likely result in serious questions being raised concerning the SEC's ability to seek disgorgement in other aspects of its enforcement agenda. As the SEC moves ahead, both the SEC and those against whom disgorgement is sought will need to wrestle with *Govil* in areas where it is more difficult to identify victims who have suffered pecuniary harm resulting from the alleged securities law violations. There is a wide range of regulatory enforcement actions in which the SEC has sought disgorgement despite the absence of identifiable victims who incurred a financial loss. *Govil* puts the SEC's ability to seek disgorgement in such cases in serious question. Consider, for example, enforcement actions alleging the offering of securities without registration. In such cases, the SEC does not even allege that investors have been defrauded, let alone harmed. Going forward, it would seem that *Govil* precludes a claim for disgorgement. In Foreign Corrupt Practices Act cases, the SEC has historically sought disgorgement of profits allegedly earned by a company through business obtained or retained by virtue of an improper payment to a foreign official. After *Govil*, the SEC likewise would be challenged to identify a victim who has suffered a financial harm. In insider trading matters, the SEC routinely seeks disgorgement of imputed profits or avoided losses from defendants based on a differential between a trade price and a post-disclosure market price. However, the SEC has never undertaken, nor been required, to prove that there was an identifiable victim in the sense of a defrauded counterparty to the allegedly offending trade. And if required to meet such a burden of proof after *Govil*, one doubts that it could. Suffice it to say that the SEC likely did not foresee that the aggressive pursuit of disgorgement in a case in which Aron Govil had stipulated to liability would lead to such a potentially significant adverse impact on its broader enforcement program.

_____ [1] --- F.4th ---, 2023 WL 7137291 (2d Cir. 2023). [2] The SEC sought disgorgement pursuant to 15 U.S.C. § 78u(d)(5) and § 78u(d)(7). Although the equitable remedy of disgorgement has been used by the SEC since the 1970s, *see, e.g.*, *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082 (2d Cir. 1972), it was not until 2002 that Congress expressly authorized the SEC to "seek . . . any equitable relief that may be appropriate for the benefit of investors" in § 78u(d)(5). The Supreme Court then clarified in *Liu v. SEC* that "a disgorgement award that does not exceed a

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wrongdoer's net profits and is awarded for victims is equitable relief permissible under § 78u(d)(5)." 140 S.Ct. 1934, 1940 (2020). Congress enacted 15 U.S.C. § 78u(d)(7) six months after *Liu* narrowed the circumstances in which disgorgement is permissible, expressly authorizing the SEC to "seek . . . disgorgement" without reference to any limitations that might otherwise apply to relief already available under § 78u(d)(5). Although others courts have disagreed, the Second Circuit has previously held that the enactment of § 78u(d)(7) did not serve to undo the limitations that *Liu* imposed on the SEC's disgorgement remedy. *See SEC v. Ahmed*, 72 F.4th 379 (2d Cir. 2023) ("We read 'disgorgement' in § 78(u)(d)(7) to refer to equitable disgorgement as recognized in *Liu*.") [3] *SEC v. Govil*, 2022 WL 1639467, at *3 (S.D.N.Y. May 24, 2022). [4] 140 S.Ct. at 1940. [5] 2023 WL 7137291, at *9. [6] *Id.* at *10 n.16. [7] *Id.* at *10 (quoting *Liu*, 140 S.Ct. at 1948, cleaned up). [8] *Id.* at *11. [9] *Id.* [10] *Id*. at *12-13 (quoting *SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006)).

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