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Will the Recent Second Circuit Decision in *SEC v. Govil* Adversely Impact Future SEC Disgorgement Cases—Or Not?

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INTRODUCTION AND BACKGROUND

In 2020, the U.S. Supreme Court held in *Liu v. SEC* that disgorgement awards brought in cases by the U.S. Securities and Exchange Commission ("SEC") must satisfy a two-part test, that is, the disgorgement award (1) does not exceed the defendant's "net profits," and (2) is awarded solely for the "benefit of the victims" of the defendant's actions.[1] Previously, the U.S. Supreme Court held in *Kokesh v. SEC,* that SEC disgorgements bear all of the hallmark of a penalty.[2] As a result, SEC disgorgement awards are now subject to this "investor benefit" test. The Fifth Circuit in *SEC v. Blackburn* permitted the disgorgement award to be paid first to the SEC as the "defacto trustee" and then allowed the SEC to create a plan, subject to court approval, to pay the victims to satisfy the "investor benefit" test.[3]

In the District Court in the current case of *SEC v. Govil*, the SEC alleged that Govil misappropriated $7,335,000 from investors in a company, known as Cemtrex, and then used those funds to pay for unrelated personal expenses.[4] Govil then entered into a settlement and release agreement with Cemtrex and had agreed to pay Cemtrex $7.1 million in the form of (1) Cemtrex stock owned by Govil that was valued at $5,556,720, and (2) a promissory note in the amount of $1,533,280

that was issued by Govil.[5] The SEC argued that Govil should pay an additional $7,335,000 to the investors, and not to Cemtrex.[6] Judge J. Paul Oetken agreed with the SEC that the investors are the actual victims of Govil's misconduct as they were promised that the proceeds of the offering would be used for "various capital purposes."[7] Judge Oetken also noted that the $7,335,000 was used by Govil solely for personal expenses and was not directed toward Cemtrex.[8] He then ruled that the disgorgement amount owed by Govil should be $5,801,720, or the $7,335,000 amount less the promisory note of $1,533,280.[9] The SEC also requested the Court to order Govil to pay an additional $16,056,870 as it represented the gross pecuniary gain of the offering frauds.[10] Judge Oetken did not order this award but did require Govil to pay an additional $620,000.[11]

ANALYSIS OF THE *SEC V. GOVIL* CASE

On appeal, Govil raised two principal arguments, namely (1) that the disgorgements were not authorized under 15 U.S.C.A. § 78u(d)(5) or 15 U.S.C.A. § 78u(d)(7), and (2) that the district court erred when it failed to credit the value of his surrendered securities to Cemtrex against the disgorgement award.[12] The Second Circuit agreed on both of his claims.

As to Govil's first argument, the Second Circuit held that "disgorgement remedies available under § 78u(d)(5) and § 78u(d)(7) are limited by equitable principles" citing its recent decision in *SEC v. Ahmed*.[13] It further held that equitable limitations require disgorgements must be "awarded for victims," citing *SEC v. Liu*.[14] The court then stated:

> Because a defrauded investor is not a "victim" for equitable purposes if he suffered "no pecuniary harm," the district court needed to determine that the investors Govil defrauded suffered pecuniary harm before awarding disgorgement. . . . The district court abused its discretion in making the award without that predicate determination.[15]

The court determined that disgorgement is not authorized by the Exchange Act unless there is a showing that investors "had been harmed" and that the SEC had not made such a showing.[16] The court then stated that "an investor who suffered no pecuniary harm as a result of the fraud is not a victim."[17]

As to Govil's second argument, it held that the district court erred when it failed to credit the value of his surredered securities against the disgorgement award. The court then stated:

> A defendant is only required to give back the proceeds of his securities fraud once. A wrongdoer makes a payment in satisfaction of disgorgement when he returns property to a wronged party. Govil did that by surrendering his securities to Cemtrex. . . . The district court must value the surrendered securities and credit that value against the overall disgorgement award.[18]

The court held that Govil had returned a substantial value back to Cemtrex when he "relinquished all of his shares to the company."[19] It then stated:

> The remedy of disgorgement aims to "force a defendant to give up the amount by which he was unjustly enriched" . . . . Disgorgement is not "to compensate victims" but 'to prevent wrongdoers from unjustly enriching themselves through violations. For that reason, a defendant need not return more than the amount by which he was unjustly enriched."[20]

The court then ruled that, with respect to the settlement and release agreement between Govil

and Cemtrex, the district court had erred when "it concuded that the securities surrendered to Centrex did not constitute 'fair compensation' to a wronged party."[21]

DISGORGEMENT HISTORY AND THE *GOVIL* CASE

The Second Circuit's decision in *Govil* provided an excellent history of disgorgement cases and its principles. It cited the *Texas Gulf Sulphur* case as acknowledging that the SEC may seek award other than just injunctive relief so long as the remedial relief was not a penalty.[22]

In 2002, Congress enacted § 78u(d)(5) which gave the SEC the power to request " 'any equitable relief' in SEC enforcement actions so long as that relief was "appropriate or neceessary for the benefit of investors."[23] The Supreme Court then decided *Kokesh* in 2017 on the question of whether a disgorgement award was a penalty or not.[24] *However*, it was *Liu* and subsequent cases that have more clearly defined disgorgement awards and what the SEC must prove for a disgorgement to be awarded. As noted above, *Liu* requires the SEC to prove that a disgorgement award (1) does not exceed a wrongdoer's net profits, and (2) is awarded for the benefit of victims. Following *Liu*, Congress amended § 78u as part of the National Defense Authorization Act for Fiscal Year 2021 (NDAA) by adding § 78u(d)(7), which gave the SEC the power to "seek" and federal courts the power to "order" the remedy of disgorgement.[25]

Subsequent cases followed. The Fifth Circuit in *SEC v. Hallam* held that this Congressional amendment had authorized a particular type of disgorgement that was not sublect to "equitable limitations" whereas the Second Circuit in *Govil* disagreed as noted above.[26] Moreover, the Second Circuit in *Govil* relied heavily on a prior Second Circuit case in *SEC v. Ahmed* which held that § 78u(d)(7) referred to a "remedy grounded in equity" and thus equitable limitations are imposed.[27]

The Second Circuit in *Govil* then analyzed the *Liu* and *Ahmed cases* and held that *Liu's* equitable limitations on disgorgement survived the NDAA and thus § 78u(d)(7) must comport with traditional equitable limitations.[28] It then disagreed with *Hallam* stating that *Hallam* was based on legal grounds, and not on equitable ones and that *Hallam* failed to follow the equitable principles outlined in *Liu.*[29]

IMPACT OF THE *GOVIL* CASE ON FUTURE SEC AND CFTC DISGORGEMENT CASES

The SEC has been quite successful in collecting profits from illegal trading activity over the years. One source has claimed that this amount approximated $3.37 billion in 2023 alone, more than twice what the SEC had recovered via penalty fines.[30]

If *Govil* becomes the controlling case, it would appear that the SEC may now be required to prove the pecuniary harm suffered by victims before being able to obtain a disgorgement award. If so, the question now becomes whether the SEC can more easily identify the victims who have suffered "pecuniary harm" caused by the wrongdoer. How will this test of proving such pecuniary harm impact cases involving the failure to register securities, FCPA cases, etc., where there are typically no identifiable investor? Query, should the SEC have just accepted the settlement and release agree proferred by Govil

and not sought such additional disgorgement awards from him? Hindsight can sometimes prove beneficial especially after the *Ahmed* case was decided by the Second Circuit before the SEC brought the *Govil* case.

Similarly, as to CFTC disgorgement actions, it will be interesting to see if and how the *Govil* case might impact the CFTC's attempt to request disgorgement from fraudulent trading cases and/or failure to register cases. In the crypto/digital asset cases brought to date by the CFTC, several have alleged a crypto's firm failure to register as a DCM and/or as an FCM. Will future CFTC enforcement actions seek disgorgement or just financial sanctions that go to the U.S. Treasury? To me, it's easy to identify customers who have traded that product during the period of the alleged trading fraud and/or on the unregistered crypto trading platform.

ENDNOTES:

[1]*Liu v. Securities and Exchange Commission*, 591 U.S. 71, 140 S. Ct. 1936, 207 L. Ed. 2d 401, Fed. Sec. L. Rep. (CCH) P 100851 (2020).

[2]*Kokesh v. S.E.C.*, 581 U.S. 455, 137 S. Ct. 1635, 198 L. Ed. 2d 86, Fed. Sec. L. Rep. (CCH) P 99733 (2017). See also, "Ask the Professors—How Will the Recent Supreme Court Decision in SEC v. Kokesh Affect Future SEC and CFTC Enforcement Actions?," By Professors Ronald Filler and Jerry Markham, 37 Fut. & Deriv. L. Rep (September 2017).

[3]*Securities and Exchange Commission v. Blackburn*, 15 F.4th 676, Fed. Sec. L. Rep. (CCH) P 101254 (5th Cir. 2021). See also "Ask The Professor—How Did the Fifth Circuit Interpret the "Investor Benefit" Requirement Governing Disgorgements in Blackburn?," by Professor Ronald Filler, 41 Fut. Deriv. L. Rep (December 2021).

[4]See Slip Opinion of *Securities and Exchange Commission v. Aron Govil*, 21-CV-6150 (S.D.N.Y., May 24, 2022).

[5]*Ibid.*

[6]See Slip Opinion of *SEC v. Govil*, at p. 2.

[7]*Ibid.*

[8]See Slip Opinion at p. 3.

[9]*Ibid.*

[10]See Slip Opinion at p. 4.

[11]*Ibid.*

[12]See Slip Opinion of the Second Circuit in *Securities and Exchange Commission v. Govil*, 86 F.4th 89, Fed. Sec. L. Rep. (CCH) P 101720 (2d Cir. 2023), at p. 1.

[13]*United States Securities and Exchange Commission v. Ahmed*, 72 F.4th 379, 396, Fed. Sec. L. Rep. (CCH) P 101626 (2d Cir. 2023).

[14]*Supra*, n. 1.

[15]See Slip Opinion at p. 4.

[16]See Slip Opinion at p. 12.

[17]See Slip Opinion at p. 13.

[18]See Slip Opinion at p. 5.

[19]See Slip Opinion at p. 28.

[20]See Slip Opinion at p. 29.

[21]See Slip Opinion at p. 31.

[22]See Slip Opinion at p. 14.

[23]See Slip Opinion at p. 15.

[24]See *Koekesh* article by the author, *supra*, n. 2.

[25]See Slip Opinion at pp. 15-16.

[26]*Securities and Exchange Commission v. Hallam*, 42 F.4th 316, Fed. Sec. L. Rep. (CCH) P 101429 (5th Cir. 2022).

[27]See Slip Opinion at pp. 19-20. See also *United States Securities and Exchange Commission v. Ahmed*, 72 F.4th 379, Fed. Sec. L. Rep. (CCH) P 101626 (2d Cir. 2023).

[28]See Slip Opinion at p. 16.

[29]See Slip Opinion at p. 17.

[30]Securities Law, by Matthew Buktman,

March 5, 2024, https://news.bloomberglaw.com/securities-law/secs-3-billio-enforcement-tool-on-murky-path-as-courts-split. This article provides data on the amount of disgorgement awards obtained by the SEC versus penalties between FY2018 through FY2023.