

Circ. Split May Have Big Effect On SEC Disgorgement Remedy

By **Elisha Kobre** (July 20, 2023)

In a decision issued late last month, the U.S. Court of Appeals for the Second Circuit provided new guidance on the rules governing the U.S. Securities and Exchange Commission's ability to seek the remedy of disgorgement in enforcement actions.

The new guidance continues the process of resolving uncertainty left by the U.S. Supreme Court's 2020 decision in *Liu v. SEC*, and subsequent congressional legislation amending the Securities and Exchange Act, to expressly authorize the SEC to pursue disgorgement in civil enforcement actions.



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Critically, *SEC v. Ahmed*, issued on June 28, held that *Liu*'s equitable limitations on disgorgement survived amendments to the Exchange Act that include a new provision expressly authorizing the SEC to pursue disgorgement.

This holding creates a serious split in authority with the U.S. Court of Appeals for the Fifth Circuit that may ultimately need to be resolved by the Supreme Court.

The Second Circuit also took a broad approach to *Liu*'s holding that disgorgement be limited to net profits — a requirement imposed by *Liu* in recognition of disgorgement's equitable roots — declining to reduce disgorgement by the defendant's costs of executing the fraud because the transactions were "entirely tainted" by his failure to disclose conflicts of interests in the transactions.

Finally, in one of the first circuit court cases to address the issue, the Second Circuit applied *Liu* to vacate an award for supplemental enrichment, holding that the award of actual gains earned during the asset freeze was not, without further analysis, consistent with *Liu*'s general guideposts for equitable relief.

Liu and the Subsequent 2021 Exchange Act Amendments

The Supreme Court's 2020 *Liu* decision held that disgorgement was a form of equitable relief authorized under the Exchange Act, even though the act did not, at the time, expressly authorize the remedy.

However, *Liu* imposed several requirements on disgorgement to ensure that it would be applied in a way that was true to its equitable roots. *Liu* thus held that disgorgement may "not exceed a wrongdoer's net profits" and must be "awarded for victims."

Shortly after *Liu*, Congress amended the Exchange Act to explicitly authorize the SEC to pursue disgorgement. The same legislation extended the statute of limitations for disgorgement from five years to 10 years, and made both of these provisions retroactive to any action or proceeding pending at the time of its enactment.

SEC v. Ahmed

SEC v. Ahmed was an enforcement action alleging that Iftikar Ahmed had defrauded his former employer — a venture capital firm name Oak Management Corp. — and its investors

of some \$65 million.

Ahmed's role at Oak was to identify and recommend portfolio companies in which Oak would invest, and to negotiate the terms of those investments.

As alleged, Ahmed's fraud involved funneling Oak funds to himself under various false pretenses, including by obtaining interests in the portfolio companies on his own and then causing Oak to purchase those interests while concealing that the interests belonged to him personally.

Oak thus obtained interests in the portfolio companies — which Ahmed argued were at bargain prices — but only acquired those interests through Ahmed's misrepresentations and failure to disclose his conflicts of interests.

Following the filing of the complaint, the U.S. District Court for the District of Connecticut granted the SEC a preliminary injunction and issued an order freezing approximately \$120 million.

The court ultimately entered summary judgment for the SEC and awarded substantial amounts in disgorgement, civil penalties, prejudgment interest for the period before the asset freeze, and "actual returns on the frozen assets" during the pendency of the asset freeze.

Ahmed's Notable Holdings

The Ahmed decision is notable for three significant holdings on the SEC's disgorgement powers.

First, the Second Circuit held that "Liu's equitable limitations on disgorgement survive" the Exchange Act amendments expressly authorizing disgorgement.

As noted, shortly after Liu, Congress amended the Exchange Act to add a provision explicitly authorizing disgorgement. There are therefore now two provisions in the Exchange Act authorizing disgorgement: (1) the provision for equitable relief, interpreted by Liu to implicitly include disgorgement, and (2) the new provision explicitly authorizing the SEC to seek disgorgement.

In a 2022 case, SEC v. Hallam, the Fifth Circuit held that the new express disgorgement provision "authorize[d] legal 'disgorgement' apart from the equitable 'disgorgement' permitted by Liu" and questioned "whether equitable disgorgement ... survived the ... Exchange Act amendments."

Under the Fifth Circuit's approach, the equitable constraints on disgorgement set forth in Liu would not apply to the new legal disgorgement authorized by the amendments. In other words, the Liu constraints would not apply.

The Second Circuit in Ahmed expressly disagreed, holding that both the earlier provision authorizing equitable relief as interpreted by Liu, and the new provision expressly authorizing disgorgement, both refer to equitable disgorgement subject to the constraints set forth in Liu.

In reaching this conclusion, the Second Circuit relied upon the well-established understanding of the term "disgorgement" as referring to the remedy rooted in equity as

well as the statutory history of the Exchange Act amendments, which were obviously intended as — in the court's words — "a 'belt and suspenders' clarification that equitable disgorgement is available under the Exchange Act."

The circuit split, which Ahmed made explicit by calling out its disagreement with the Fifth Circuit, is significant because it means that the Second Circuit will apply Liu's requirements to limit disgorgement awards, while the Fifth Circuit will permit legal disgorgement to which Liu's strictures do not apply.

And there would be no reason for the SEC in future cases within the Fifth Circuit to limit its recovery by seeking disgorgement under the Exchange Act's equitable relief provision.

Second, while recognizing Liu's requirement that disgorgement not exceed the wrongdoer's net profits, the court applied that principle narrowly to affirm a disgorgement amount that did not consider Ahmed's cost of the securities that he fraudulently caused Oak to purchase.

Instead, the court imposed disgorgement in the total amount of the transactions, finding that Ahmed's misconduct was "not in misrepresenting the purchase prices but in failing to disclose his conflicts of interest, which violated the Investment Advisers Act."

As a result, the Second Circuit held that the transactions were "entirely tainted" and therefore Ahmed's entire "profits from the transactions constituted his 'net profits from wrongdoing' under Liu."

This was true even though those profits included costs incurred by Ahmed. The same reasoning would apply anytime a transaction has its genesis in misrepresentations or self-dealing, rendering Liu's net-profits requirement a nullity in those circumstances.

The court also cited the principle that the risk of uncertainty affecting the size of disgorgement should be borne by the wrongdoer. But the facts of Ahmed suggest that the issue there was less the uncertainty of the amount, but rather the court's determination that the "fact that Oak, a victim of Ahmed's fraud, might have gotten a 'bargain' on the share purchase should not redound to the fraudster's benefit."

This suggests that, even where a net profits calculation can be made with certainty, disgorgement still should not be reduced to unduly benefit the defendant.

Finally, the court reversed the district court's award of supplemental enrichment for Ahmed's gains on the illicit proceeds of the fraud during the period of the SECs asset freeze.

Supplemental enrichment encompasses the opportunity cost or time value of money lost by victims during the period when the defendant was under a duty to, but did not, pay damages, such as the period of the asset freeze in Ahmed.

The district court had awarded supplemental enrichment for the period of the asset freeze in the amount of the "actual returns on the frozen assets," which the court also termed "actual gains," without elaboration or limitation based upon Ahmed's profitable uses of the frozen assets.

The Second Circuit held that this was improper because an award of supplemental enrichment is also subject to Liu's equitable requirements.

Although the court generally left it to the district court to conform its supplemental

enrichment award to Liu's equitable requirements, it directly imposed one limitation on consequential gains: They "must not be unduly remote," in the sense that disgorgement of profits earned on the proceeds of the fraud must be sufficiently attributable to the underlying wrong.

Few courts have dealt with this issue, and Ahmed will likely lead the way in how Liu should be applied to supplemental enrichment awards.

Conclusion

Ahmed is consequential because it confirms, contrary to the Fifth Circuit, that Liu's equitable requirements apply even in the wake of the Exchange Act amendments and provides additional guidance on applying Liu's standards to disgorgement and supplemental enrichment.

The impact of the equitable constraints on disgorgement imposed by Liu will be significantly affected by the conflict between the Second and Fifth Circuits.

In the Second Circuit, every judgment in an SEC civil enforcement action will need to conform to Liu. In the Fifth Circuit, none will, because going forward the SEC will presumably always just seek legal disgorgement under the Exchange Act amendments.

The issue will soon reach other courts of appeals. Indeed, in the Ninth Circuit, the U.S. District Court for the Central District of California — noting that its circuit had not yet addressed the issue — just last week sidestepped the issue by finding the disgorgement appropriate "even under Liu" in *SEC v. Barry/BAK West Inc.*

But there are bound to be cases coming soon where the applicability, or not, of Liu will make a difference. Depending upon where the other appellate courts land on this issue, and the number of cases in which Liu's equitable constraints make a dispositive difference, the Supreme Court may well be required to weigh in before long.

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