12-2021

Ask the Professor—How Did the Fifth Circuit Interpret the "Investor Benefit" Requirement Governing Disgorgements in Blackburn

Ronald Filler

REPORT

The Journal on the Law of Investment & Risk Management Products

Futures & Derivatives Law

December 2021 ▪ Volume 41 ▪ Issue 11

ASK THE PROFESSOR—HOW DID THE FIFTH CIRCUIT INTERPRET THE "INVESTOR BENEFIT" REQUIREMENT GOVERNING DISGORGEMENTS IN *BLACKBURN*

By Professor Emeritus Ronald Filler

Ronald Filler is a Professor Emeritus and the Chair of the Ronald H. Filler Institute on Financial Services Law at New York Law School. He has taught courses on Derivatives Law, Securities Regulation, the Regulation of Broker-Dealers and FCMs and other financial law issues since 1977 at four different U.S. law schools. Prof. Filler is a Public Director of the National Futures Association, a Public Director and Member and Chair of the Regulatory Oversight Committee of Swap-Ex, a swap execution facility owned by the State Street Corporation, and has served on the boards of various exchanges, clearing houses and industry trade associations. Before joining the NYLS faculty in 2008, he was a Managing Director in the Capital Markets Prime Services Division at Lehman Brothers Inc. in its New York headquarters. Prof. Filler has co-authored, with Prof. Jerry Markham, "Regulation of Derivative Financial Instruments (Swaps, Options and Futures)." He provides expert witness testimony and consulting services relating to a variety of issues involving the financial services industry. You can reach Prof. Filler via email at: ronald.filler@nyls.edu.

INTRODUCTION

In *Kokesh v. SEC*,[1] the U.S. Supreme Court held that a disgorgement action brought by the SEC was indeed a penalty under 28 U.S.C.A. § 2462. Section 2462 states:

> "[e]xcept as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any *civil fine, penalty, or forfeiture,* pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued. . . ."[2]

The principal issue before the Supreme Court in *Kokesh* was whether an action for disgorgement brought by the U.S. Securities and Exchange Commission in an enforcement action was subject to this five-year statute of limitation (now amended to, in many cases, extend to 10 years[3]) or whether it constituted an equitable remedy and therefore was not a "fine, penalty or forfeiture" subject to the five-year limitation period.[4] While the *Kokesh* case primarily focused on this five-year limitation period, the Supreme Court also held that "a 'penalty' is a 'punishment,' whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws."[5] Therefore, to analyze whether disgorgement is in fact a penalty, two main principles apply.

THOMSON REUTERS®

42705938

First, whether a sanction represents a penalty turns in part on "whether the wrong sought to be redressed is a wrong to the public or a wrong to the individual. . . ." Second, a pecuniary sanction operates as a penalty only if it is sought "for the purpose of punishment, and to deter others from offending in like manner—as opposed to compensating a victim for his loss."[6]

Applying these principles, the Court then held:

> First, SEC disgorgement is imposed by the courts as a consequence for violating what we [have] described . . . as public laws. The violation for which the remedy is sought is committed against the United States rather than an aggrieved individual—that is why, for example, a securities enforcement action may proceed even if victims do not support or are not parties to the prosecution. As the Government concedes, "[w]hen the SEC seeks disgorgement, it acts in the public interest, to remedy harm to the public at large, rather than standing in the shoes of particular injured parties. . . . Second, SEC disgorgement is imposed for punitive purposes. . . . The primary purpose of disgorgement is to deter violations of the securities laws by depriving violators of their ill-gotten gains."[7]

The Court concluded that:

> SEC disgorgement thus bears all of the hallmarks of a penalty. It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate. The 5-year statute of limitations in § 2462 therefore applies when the SEC seeks disgorgement.[8]

THE *LIU* CASE

Three years later, the Supreme Court in *SEC v. Liu* decided that the SEC may continue to obtain disgorgements in federal court.[9] The Court in *Liu* held, however, that, to be effective, disgorgements in a SEC enforcement case must meet a two-part test, namely that the disgorged amount in a securities case: (1) does not exceed the defendant's "net profits," and (2) is awarded for the "benefit" of the victims of the defendant's misconduct. On the first item, Justice Sonia Sotomayor wrote that "Courts may not enter disgorgement awards that exceed the gains" made after accounting for expenses.[10]

But what constitutes an award for the "benefit" of the victims of misconduct? Justice Sotomayor provided some guidance, noting that "the SEC's equitable, profits-based remedy must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains."[11] However, it is the Fifth Circuit *Blackburn* case where, for the first time, a U.S. Court of Appeals has provided more guidance as to what constitutes the "award for victims" question addressed in *Liu*.[12]

ANALYSIS OF THE *BLACKBURN* CASE

Ronald Blackburn founded Treaty Energy Corporation in 2008. Treaty was a small oil and gas company, the shares of which were traded over the counter as "penny stocks." Although never listed as an officer or director of Treaty, Blackburn owned approximately 86% of Treaty's shares and thus he was deemed to be in control of Treaty. Blackburn had been previously convicted of four federal tax felonies. The SEC brought an enforcement action against Blackburn and other officers of Treaty and alleged, among other things: (1) the defendants failed to register millions of Treaty shares in violation of Section 5 of the Securities Act of 1933, (2) Blackburn and another defendant misrepresented the company's drilling results to investors, and (3) two of the other defendants deceived investors about Blackburn's role in Treaty directly and through the Form 10-K filed with the SEC.

Both the SEC and the individual defendants filed a motion for summary judgment. The district court denied the motion filed by the defendants but granted the motion filed by the SEC. The district court judge concluded that the defendants violated Section 5 of the 1933 Act, that they violated Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder, and violated Section 17(a) of the 1933 Act by misrepresenting Treaty's oil production and Blackburn's role in Treaty. The district court imposed several nonmonetary remedies, including prohibiting the defendants from acting as officers or directors of any publicly-held company but also ordered "disgorgement" of profits and imposed civil monetary penalties.[13]

THE FIFTH CIRCUIT OPINION

The Fifth Circuit accepted the findings of the district court judge and affirmed the lower court's order to grant the motion for summary judgment requested by the SEC. It then focused on the "disgorgement" remedy granted by the district court. It noted first that the 1934 Act authorizes the SEC to seek "equitable relief" that may be appropriate or necessary for "the benefit of investors."[14] In citing *Liu*, the Fifth Circuit acknowledged that "equity practices long authorized courts to strip wrongdoers of their ill-gotten gains."[15] To allow any such disgorgement, the equitable relief cannot be punitive and thus "cannot exceed the defendants' 'net profits' and must be 'awarded for [the] victims.' "[16]

The Fifth Circuit then held that the district court's order clearly satisfied the two tests noted in *Liu*. It stated:

> First, the disgorgement amounts are the profits defendants received from their securities fraud: $1,512,059.96 for Blackburn, $108,291.05 for Mulshine and $772,434.90 for Gwyn. As those figures show, the district court did not impose joint-and-several liability but individually addressed each defendant's gain.
>
> Second, the district court concluded that the SEC had identified the victims and created a process for the return of disgorged funds. Under the district court's supervision, any funds recovered will go to the SEC, acting as a de facto trustee. The SEC will then disburse those funds to victims but only after district court approval.[17]

The Fifth Circuit added that while the district court's order "requiring disbursements to already-identified victims with court supervision to ensure compliance with that edict" was clearly in accord with *Liu*, it is not "the only way to satisfy *Liu* as . . . [other] cases may present greater challenges for ensuring that disgorgement benefits victims."[18]

In its brief filed before the Fifth Circuit, the SEC emphasized the *Liu* test and the traditional role of equity courts in awarding recovery for unjust enrichment:

> Section 21(d)(5) authorizes the Commission to seek, and courts to award, "equitable relief that may be appropriate or necessary for the benefit of investors." *Liu* held that Section 21(d)(5) authorizes "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims', and that such recovery of unjust enrichment is a "mainstay of equity courts."[19]

The SEC additionally sought to reserve the ability in some cases to award disgorgement funds to the Department of the Treasury instead of to victims, asserting that:

> The Supreme Court further stated that the "equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for their benefit." The Court left "open" whether "depositing disgorgement funds with the Treasury may be justified where it is infeasible to distribute the collected funds to investors."[20]

CONCLUSION

During the *Blackburn* litigation, the district court initially ruled that the disgorged amounts were to be distributed to the SEC and then placed in the U.S. Treasury. The defendants appealed that initial lower court decision and, before the Fifth Circuit could rule on this, the Supreme Court issued the *Liu* decision. In accord with *Liu*, it was remanded back to the district court to modify the initial disgorgement order. The district court then ordered that the disgorged amount would, as noted above, be paid to the SEC as the "de-facto trustee" but that any actual disgorgement plan would need court approval.

In *Blackburn*, the lower court's model clearly establishes a method that allowed the SEC to make disgorgements consistent with *Liu* and, therefore, with low risk of being successfully challenged. This practical, fact-specific model should easily be upheld in future cases. The question becomes what other disgorgement models will be accepted in lieu of *Liu*? Can a lower court approve, as did the initial lower court decision, merely placing the disgorged amounts in the U.S. Treasury? Will the "benefit to investors" test be upheld by the courts if the SEC can identify only some, but not all, of the shareholders? Finally, with the express authorization of the SEC's ability to seek disgorgement in the National Defense Act of 2021, how will future courts interpret this more-robust statutory authority differently than the Court in *Liu*?[21]

ENDNOTES:

[1]*Kokesh v. S.E.C.*, 137 S. Ct. 1635, 198 L. Ed. 2d 86, Fed. Sec. L. Rep. (CCH) P 99733 (2017).

[2]28 U.S.C.A. § 2462 (emphasis added).

[3]National Defense Act of 2021, Pub. L. 116-283 (Jan. 1, 2021), § 6501.

[4]*See* Ron Filler and Jerry Markham, *Ask the Professors—How Will the Recent Supreme Court Decision in* SEC v. Kokesh *Affect Future SEC and CFTC Enforcement Actions?*, 37 Fut. & Deriv. L. Rep. (Sept. 2017).

[5]*Ibid.*

[6]*Ibid.*

[7]*Ibid.*

[8]*Ibid.*

[9]*Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936 at 1942, 207 L. Ed. 2d 401, Fed. Sec. L. Rep. (CCH) P 100851 (2020).

[10]*Id.* at 1949.

[11]*Id.* at 1948.

[12]*Securities and Exchange Commission v. Blackburn*, 15 F.4th 676, Fed. Sec. L. Rep. (CCH) P 101254 (5th Cir. 2021).

[13]*Id.* at 680.

[14]15 U.S.C.A. § 78u(d)(5).

[15]*SEC v. Blackburn,* 15 F.4th at 681 *citing Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936, 1942, 207 L. Ed. 2d 401, Fed. Sec. L. Rep. (CCH) P 100851 (2020).

[16]*Id.* at 682 *citing Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936, 1942, 207 L. Ed. 2d 401, Fed. Sec. L. Rep. (CCH) P 100851 (2020).

[17]*SEC v. Blackburn,* 15 F.4th at 682.

[18]*Id.* at 683.

[19]See Brief of Securities and Exchange Commission, Appellee, filed before the Fifth Circuit in the *Blackburn* case at p. 20. See also Section 21(d)(5) of the 1934 Act, 78u(d)(5).

[20]*Ibid.*

[21]Pub. L. 116-283.