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Circuit Decision Provides SEC Roadmap to Seek Disgorgement Post-Liu

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On October 12, the Fifth Circuit Court of Appeals affirmed a district court's decision in *SEC v. Blackburn*, awarding disgorgement to alleged victims of a penny stock fraud scheme subject to SEC enforcement action.^[1] This decision signifies the first time that a circuit court has interpreted the new standard by which the SEC may seek disgorgement under the Supreme Court's *Liu v. SEC* decision.

Background

The Exchange Act authorizes the SEC to seek "equitable relief" that "may be appropriate or necessary for the benefit of investors." See 15 U.S.C. § 78u(d)(5). In June 2020, the Supreme Court in *Liu* upheld the SEC's authority to seek disgorgement as an equitable remedy under this statute, but established limitations on that authority. Specifically, to qualify as an equitable remedy, the SEC can only seek the defendant's net profits, which must be awarded to benefit the victims. Although the decision in *Liu* secured the SEC's authority to seek disgorgement, the opinion suggested that the SEC will have to continue litigating the parameters of the SEC's disgorgement authority.

Blackburn Decision

The recent *Blackburn* decision is the first time that a circuit court has evaluated the parameters of the SEC's disgorgement authority, as defined in *Liu*. In *Blackburn*, the SEC charged three defendants with selling unregistered securities and misleading investors during their operation of penny stock company Treaty Energy Corporation (Treaty). Treaty claimed it planned to develop crude oil and natural gas. Treaty was founded, controlled, and run by Ronald Blackburn, who did not have a formal role at Treaty but was its major shareholder. To demonstrate Blackburn's control over Treaty, the court found that Blackburn owned 86.6% of Treaty's stock, "Blackburn communicated with a foreign government on behalf of Treaty, paid the company's bills with his stock proceeds, and appointed Treaty's officers and directors."

Blackburn had a history of criminal convictions and civil claims involving corporate malfeasance. Before founding Treaty, Blackburn was convicted of four federal tax felonies, and in another matter, he was forced to pay \$1 million to satisfy a trustee's claim that Blackburn misappropriated company funds. However, for Treaty, Blackburn recruited people with clean records to serve as officers of Treaty. According to the SEC, Blackburn actually ran the

company, but his involvement was not disclosed in periodic filings with the SEC or other materials. The SEC also alleged that Blackburn, along with his handpicked officers, misrepresented Treaty's drilling results to investors.

The Fifth Circuit's decision references Blackburn's background by, among other things, noting that a Treaty investor allegedly told a Treaty officer that if Blackburn was involved in managing Treaty, "he did not want to invest — he had lost over \$450,000 investing in the gravel pit company after Blackburn had guaranteed it had a 'positive outlook.'" Despite Blackburn's significant control over Treaty, the Treaty officer assured the investor that Blackburn was not involved. Based on these assurances, the investor invested in Treaty, but ultimately lost \$20,000 from it. Further and unsurprisingly, Treaty's filings did not mention Blackburn by name and instead referred to him as a "major shareholder," an "affiliate," and a "related party."

The district court granted the SEC's motion for summary judgment and ordered the defendants to pay nearly \$2.4 million in disgorgement based on losses that Treaty investors suffered from the defendants' misrepresentations. The Fifth Circuit found that the lower court's order was consistent with the limitations set out in *Liu*. The order did not impose joint-and-several liability, but instead assessed each defendant's gain and disgorgement amount. The SEC also identified victims and created a process to return disgorged funds to them. Under the district court's supervision, any funds recovered will go to the SEC, acting as a *de facto* trustee. The SEC will disburse those funds to victims, but only after district court approval. The Fifth Circuit found that the process outlined by the SEC satisfied the standards articulated in *Liu*.

The *Blackburn* decision provides a roadmap for how the SEC may pursue disgorgement and comply with the new limitations. When the SEC seeks disgorgement in future matters, it will likely abide by a similar process and identify specific victims to whom disgorgement funds will be disbursed.

[1] SEC v. *Blackburn et al.*, Case No. 20-30464 (5th Cir. 2021).

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