Client Update

U.S. Supreme Court Holds SEC Disgorgement Is a Penalty Subject to a Five-Year Statute of Limitations

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On June 5, 2017, the United States Supreme Court unanimously held that the "catch-all" statute of limitations for government actions in 28 U.S.C § 2462 bars the U.S. Securities and Exchange Commission ("SEC") from obtaining disgorgement in actions brought beyond the five-year limitations period. Interpreting the scope of § 2462 and expanding on its landmark ruling in *Gabelli v. SEC*,[1] the Court rejected the government's argument that disgorgement is remedial in that it "restores the status quo," and held that "[b]ecause disgorgement orders go beyond compensation, are intended to punish, and label defendants wrongdoers as a consequence of violating public laws, they represent a penalty and thus fall within the 5-year statute of limitation of § 2462." The impact of the decision may well be far-reaching. With this logic, the Court's decision significantly limits the SEC's ability to pursue a key remedy; impacts the SEC's leverage in settlement discussions for certain types of cases, including FCPA cases; complicates decisions on whether to toll the statute of limitations; appears to raise significant questions as to whether other SEC sanctions, such as bars and even injunctions—previously thought to be "remedial" in nature—likewise represent penalties and are thus constrained by the five-year limitations period; and sets up a potential challenge more broadly to the SEC's authority to obtain disgorgement in enforcement actions.

FACTUAL BACKGROUND

In 2009, the SEC brought an action against Charles Kokesh alleging that he misappropriated $ 34.9 million from two investment-advisory firms he owned and caused the filing of false and misleading SEC reports and proxy statements to conceal that wrongful conduct. The SEC sought civil penalties, disgorgement

[1] 133 S.Ct. 1216 (2013). In *Gabelli*, the Court held that the discovery rule does not apply to 28 U.S.C. § 2462, meaning that the SEC must bring an enforcement action for civil penalties within five years of the completion of the alleged wrongful conduct.

and an injunction barring Kokesh from future violations of the federal securities laws. Kokesh's alleged wrongdoing included conduct within the five-year statute of limitations, as well as conduct preceding it.

Kokesh was found liable for various securities laws violations in a jury trial. The district court held that § 2462 precluded any penalties for misappropriation that had occurred prior to October 27, 2004—five years prior to the date the SEC filed the complaint. However, the court held that the Commission's request for a $34.9 million disgorgement judgment was not a "penalty" within the meaning of § 2462 and therefore no limitations period applied. The court ordered Kokesh to pay the $34.9 million in disgorgement—$29.9 million of which related to conduct outside the limitations period—and $18.1 million in prejudgment interest. Kokesh appealed.

THE TENTH CIRCUIT'S DECISION

On appeal, Kokesh asserted that the SEC's suit was time-barred. Under 28 U.S.C. § 2462, a five-year statute of limitations applies to any "civil fine, penalty or forfeiture." Kokesh argued that disgorgement amounts to either a penalty or forfeiture and therefore was subject to the statute of limitations.

The Tenth Circuit in *SEC v. Kokesh* first held that disgorgement is not a penalty under § 2462, noting that it is remedial and when "[p]roperly applied … does not inflict punishment."[2] The court then addressed whether disgorgement could be considered a forfeiture. While acknowledging that the terms "forfeit and disgorge … capture similar concepts," the Tenth Circuit concluded that forfeiture under § 2462 should be interpreted narrowly as a purely punitive remedy.[3] Disgorgement, the court held, is a nonpunitive remedy and "does not fit in that company."[4] In reaching this conclusion, the Tenth Circuit expressly disagreed with a June 2016 opinion by the Eleventh Circuit in *SEC v. Graham*, which held that the terms "disgorgement" and "forfeiture" substantively overlapped such that disgorgements were forfeitures subject to the limitations period in § 2462.[5]

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2 834 F.3d 1158, 1164 (2016).

3 *Id.* at 1166.

4 *Id.*

5 *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016).

THE SUPREME COURT'S RULING

The Supreme Court granted certiorari in *Kokesh v. SEC* to resolve the circuit split over whether § 2462 applies to claims for disgorgement in SEC enforcement actions.[6] After affirming the principle set out in *Gabelli* that statutes of limitations specifying when exposure to government enforcement efforts end are "vital to the welfare of society," the Court held that SEC disgorgement constitutes a penalty subject to the five-year limitations period in § 2462.

Whether a sanction is a penalty, the Court held, turns on two key queries: (i) whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual; and (ii) whether the penalty is sought for the purposes of punishment and deterrence of future violations or to compensate a victim for his or her loss.

The Court found that "[a]pplication of these principles to the case at hand readily demonstrates that SEC disgorgement constitutes a penalty within the meaning of § 2462." First, in bringing enforcement actions for disgorgement, the SEC acts to remedy public wrongs, not to stand in the shoes of an individual victim—a point that the government conceded. Second, the Court held that "SEC disgorgement is imposed for punitive purposes." In support of that conclusion, the Court cited cases emphasizing that the purpose of SEC disgorgement is deterrence, and stated that "[s]anctions imposed for the purpose of deterring infractions of public laws are inherently punitive because deterrence is not a legitimate nonpunitive governmental objective." Finally, the Court noted that, in many cases, SEC disgorgement is not compensatory because the funds are paid to the district court, which is under no statutory obligation to distribute disgorged funds to victims.

In so holding, the Court rejected the government's argument that disgorgement is inherently remedial. The Court noted that disgorgement is often—as it was in this case—ordered without consideration of expenses that reduce the defendant's illegal profits, leaving the defendant "worse off." And while the Court acknowledged that disgorgement may, in some cases, serve compensatory goals, it is enough, the Court held, that disgorgement cannot be said to be "solely remedial." Citing *Gabelli*, the Court found that because "disgorgement orders go beyond compensation, are intended to punish, and label defendants wrongdoers as a consequence of violating public laws, they represent a penalty and thus fall within [§ 2462]."

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[6] 581 U.S. ___ (2017).

IMPACT OF THE *KOKESH* RULING

The *Kokesh* decision appears likely to have several important effects on SEC enforcement actions (and other related matters) going forward.

Reduced Leverage for the SEC in Settlement Negotiations

The decision significantly impacts the leverage available to the SEC in enforcement actions that span many years. Absent the spectre of litigation with monetary exposure extending beyond five years, the SEC will have reduced leverage in settlement negotiations. In the past, parties may have faced significant disgorgement liability for conduct more than five years old and agreed to a settlement for a narrower time frame to avoid that exposure. The application of the five-year time bar to disgorgement actions may have an especially meaningful effect on SEC actions involving violations of the Foreign Corrupt Practices Act (FCPA), as virtually every FCPA settlement in 2016 included disgorgement and prejudgment interest and the difficulties involved in those years-long investigations often result in proceedings concerning aged alleged violations. Other areas with long-running conduct, including some asset management cases like *Kokesh*, may also be impacted.

Fewer Investigations Involving Aged Conduct

This decision could impact the SEC's decisions about where to devote resources. The SEC may be less likely to pursue investigations involving older conduct, and certainly will feel pressure to further improve the efficiency of its investigations. Relatedly, the SEC may be less flexible in negotiating lower levels of civil monetary penalties given the potential for reduced disgorgement.

Early Staff Requests for Tolling Agreements

In the conduct of their investigations, the SEC can be expected to focus on securing tolling agreements to extend the limitations period as much as possible during investigations and negotiations. Parties, however, may not feel the same pressure to sign tolling agreements now that disgorgement will be limited to the five-year period.

Cascaded Effects on Other Sanctions

Although the *Kokesh* decision provides much needed clarity on the question of whether the § 2462 time bar limits disgorgement in SEC enforcement actions, the decision raises critical questions around the impact of § 2462 on other SEC sanctions.

In particular, the SEC is permitted to seek various other remedies (beyond penalties and disgorgement) including injunctive relief and officer, director and industry or associational bars.[7] The current state of the law on whether these remedies are subject to the limitations period in § 2462 is mixed. Although many courts have held that SEC enforcement actions seeking these equitable remedies are not subject to any limitations period, several courts have found these remedies to be punitive in nature and subject to the five-year limitations period.[8] Now, however, armed with the Court's analysis of what constitutes a "penalty," defendants may find additional success in arguing that they are penalties subject to § 2462. Where, for example, a defendant in an SEC enforcement action is barred from serving as a director or officer of a public company as a result of a federal securities law violation, such a bar may arguably meet each of the *Kokesh* criteria because (i) SEC enforcement actions are brought in the public interest; (ii) the bar is intended to deter future violations; and (iii) the bar does not compensate victims. Ultimately, having lost both *Gabelli* and now *Kokesh*, it remains to be seen whether the SEC will continue to advance any theories that provide them with unlimited time to bring actions and obtain remedies.

Implications for Disgorgement in Ongoing Investigations

The application of the *Kokesh* decision will be especially problematic in disgorgement actions currently pending but not yet final and in ongoing investigations, as there may be significant confusion as courts and parties attempt to adjust to this limit on the SEC's enforcement powers.

Impact on Reimbursement, Indemnification and Deductibility of Disgorgement Payments

The finding that disgorgement amounts to a penalty could have an impact on the availability of reimbursement, indemnification and deductibility of disgorgement payments. The SEC has for years precluded indemnification for penalties, and many insurance policies likewise preclude reimbursement of penalties. SEC settlements generally do not preclude defendants from seeking indemnification or reimbursement for disgorgement. There has also been an ongoing debate as to whether disgorgement is deductible, with a recent chief

7 15 U.S.C. § 78u(d)(1)-(6).

8 *Compare SEC v. Kelly*, 663 F. Supp. 2d 276, 286-287 (S.D.N.Y. 2009) ("[T]he great weight of the case law in this jurisdiction supports the SEC's contention that equitable remedies are exempted from § 2462's limitations period.") *and S.E.C. v. Jones*, 476 F. Supp. 2d 374, 386 (S.D.N.Y. 2007) ("disgorgement is remedial and not punitive.") *with S.E.C. v. Bartek*, 484 F. App'x 949, 957 (5th Cir. 2012) (finding remedies of injunctive relief and an officer-and-director bar "punitive [and] thus subject to § 2462's time limitations.").

counsel advice memo from the IRS calling the deductibility of disgorgement as an expense into question. The *Kokesh* decision will lead to arguments that because disgorgement is a penalty, it is not subject to indemnification and is not deductible.

Additional Challenges Coming

The *Kokesh* decision will certainly give rise to challenges to the use of disgorgement in SEC enforcement proceedings; the Court explicitly did not decide "whether courts possess authority to order disgorgement in SEC enforcement proceedings or … whether courts have properly applied disgorgement principles in this context." A court holding that the SEC lacks authority to obtain disgorgement at all could have an even more significant impact on SEC actions and remedies.

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Please do not hesitate to contact us with any questions.