Securities Litigation Alert

June 9, 2017

Key Points

- Supreme Court unanimously holds that disgorgement is a "penalty" within the meaning of 28 U.S.C. § 2462, and thus subject to a five-year statute of limitations
- Because some courts had previously allowed disgorgement of all ill-gotten gains (or avoided losses) without limitation, the Supreme Court's decision has blunted a powerful SEC enforcement weapon
- *Kokesh* is likely to push the Division of Enforcement to accelerate investigation and enforcement of cases, and more aggressively seek tolling agreements, in order to maximize the SEC's disgorgement recovery

Kokesh v. SEC: Supreme Court Reins in SEC's Powerful Disgorgement Remedy

This week, the Supreme Court in *Kokesh v. SEC* unanimously held that the Securities and Exchange Commission's (SEC) equitable disgorgement remedy is subject to a five-year statute of limitations because it is a "penalty" within the meaning of 28 U.S.C. § 2462, which governs "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture." Before *Kokesh*, some circuits had held that the SEC could obtain disgorgement of the entire amount of the ill-gotten gains or losses avoided, even those that extended well beyond the five-year statute of limitations associated with most federal securities laws. *Kokesh* clarifies that both civil penalties and disgorgement are subject to the same five-year limitations period.

Background. The SEC filed a complaint against Charles Kokesh in 2009 alleging violations of various securities laws by concealing his misappropriation of $34.9 million from four business development companies beginning in 1995. The SEC sought monetary civil penalties, an injunction barring Kokesh from future violations and disgorgement of all ill-gotten gains. After a jury found Kokesh liable, the district court applied the five-year limitations period under § 2462 to the civil penalties but not to the disgorgement order, on the ground that disgorgement was not a "penalty" within the meaning of § 2462. The practical effect was that Kokesh was required to disgorge $29.9 million in ill-gotten gains from outside the five-year limitations period (as well as $18.1 million in prejudgment interest). The 10th Circuit affirmed.

The Supreme Court granted certiorari to resolve a circuit split on whether disgorgement is encompassed within § 2462's five-year statute of limitations, and unanimously reversed. Justice Sotomayor's opinion

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noted two general characteristics of a “penalty”: first, penalties redress wrongs to the public, rather than to an individual; and second, penalties are imposed “for the purpose of punishment, and to deter others from offending in like manner,” rather than to compensate victims. Applying these principles, the Court held that disgorgement by the SEC constitutes a “penalty” within the meaning of § 2462.

On the first point, the Court held that the SEC imposes disgorgement as a consequence for violating public laws, because the violation for which the remedy is sought is committed against the United States. As for the second point, the Court explained that the SEC’s use of disgorgement for “deterrence” against future violations constitutes a “punitive” purpose. The Court observed that SEC disgorgement orders are often not compensatory to victims of wrongdoing; rather, disgorged sums are paid to the district courts, which have the discretion to distribute the funds to victims but have no statutory command to do so. The Court also cited securities cases where disgorged funds were dispersed to the U.S. Treasury instead of to victims because the courts had found feasibility problems with compensating victims. Accordingly, the Court held that disgorgement operates primarily to punish instead of compensate.

Notably, the Court clarified in a footnote that its opinion does not address the questions of “whether courts have properly applied disgorgement principles in this context” or even “whether courts possess authority to order disgorgement in SEC enforcement proceedings” at all. That footnote may well spur future challenges to the SEC’s pursuit of disgorgement remedies.

Bottom Line. The Supreme Court’s *Kokesh* decision blunts one of the SEC’s most powerful enforcement weapons and promises to have several immediate effects. First, *Kokesh* is likely to push the Division of Enforcement to accelerate investigation and enforcement of cases, and more aggressively seek tolling agreements, in order to maximize the SEC’s disgorgement recovery. Second, the case explicitly opens the door for the defense bar to challenge whether courts possess authority to order disgorgement at all in SEC proceedings. Third, *Kokesh* may be a signal of future losses to come for the SEC and its enforcement programs. Another circuit split—this one relating to the constitutionality of the SEC’s administrative law judges—may find its way to the Supreme Court in the next term. *See Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016) (disagreeing with D.C. Circuit and holding that SEC administrative law judge hirings unconstitutionally violate of Appointments Clause).

To learn more about how this decision may affect Federal Energy Regulatory Commission (FERC) enforcement cases, please read our Speaking Energy blog post here.

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