

# PUBLICATION

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## Supreme Court Deals Major Blow to SEC Disgorgement Claims in *Kokesh*

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The U.S. Securities and Exchange Commission (SEC) may now only collect disgorgement from defendants within five years of filing suit. On June 5, the United States Supreme Court ruled unanimously that the five-year statute of limitations under 28 U.S.C. § 2462 governing civil fines, penalties or forfeitures, applies to limit actions for civil disgorgement. The Supreme Court's decision serves as a major setback for the SEC's efforts to aggressively pursue disgorgement in cases that were only able to be filed after extensive investigation, or cases that attempt to tackle long-running fraud schemes.

### Background

In October 2009, the SEC filed a complaint in the District of New Mexico, alleging that from 1995 – 2006, Charles Kokesh, the owner of several registered investment advisory firms (RIAs), misappropriated funds from business development companies (BDCs) in order to pay salaries and bonuses to the RIA officers, including himself. The SEC also alleged that in 2000, Kokesh initiated \$6.1 million in payments, of which he received more than 90 percent. Those payments were described in SEC reports signed by Kokesh as "tax distributions," even though Kokesh only paid approximately \$10,000 in federal taxes in 2000.

A jury found Kokesh liable for converting assets of the BDCs for his own benefit, assisting in defrauding those companies, filing false reports with the SEC and soliciting proxies by using false and misleading proxy statements. In addition to injunctive relief, the district court ordered a disgorgement of \$34.9 million, the amount that "reasonably approximate[d] the ill-gotten gains causally connected to [Kokesh's] violations," which is how disgorgement is calculated.

Kokesh appealed to the Tenth Circuit, arguing that disgorgement is either a "penalty" or a forfeiture, and, therefore, § 2462 barred the SEC's claims for disgorgement to the extent that they accrued more than five years before suit was filed. The Tenth Circuit rejected Kokesh's argument, holding that the statute did not apply because disgorgement was not a penalty.

### The Circuit Split

In reaching this conclusion, the Tenth Circuit aligned itself with the D.C. Circuit and the First Circuit in concluding that disgorgement did not constitute a penalty. *See Riordan v. S.E.C.*, 627 F.3d 1230 (D.C. Cir. 2010); *S.E.C. v. Tambone*, 550 F.2d 106 (1st Cir. 2008). However, the Tenth Circuit's decision also deepened a circuit split created by the Eleventh Circuit in *S.E.C. v. Graham*, 823 F.3d 1357, 1364 (11th Cir. 2016), in which the Eleventh Circuit found that "forfeiture includes disgorgement" and therefore concluded that "§ 2462 applies to disgorgement." The Supreme Court previously held in 2013 that the five-year limitation applies to civil penalties in civil actions filed by the SEC, but the question concerning disgorgement remained unanswered. *See Gabelli v. S.E.C.*, 133 S. Ct. 1216, 1224 (2013) (five-year limitation applies in civil actions seeking penalties from time violation of federal securities laws occurred, rather than from when government knew of or reasonably could have discovered violation).

### Supreme Court Arguments

The Supreme Court granted certiorari in *Kokesh* to decide whether § 2462's five-year statute of limitation applies to claims for disgorgement.

Oral argument in the matter focused on whether disgorgement is or is not a "penalty" or "forfeiture" under § 2462. *Kokesh* argued that the purpose of disgorgement is to impose consequences on a defendant as a result of wrongdoing, which more resembles a penalty than a remedial measure. *Kokesh* also argued that disgorgement is not purely remedial or compensatory because the SEC retains discretion on whether the disgorged funds are distributed to victims.

The SEC argued that disgorgement is not a penalty because it is an equitable remedy for unjust enrichment and limited to those funds to which the defendant was not rightfully entitled. The SEC also argued that the courts, not the SEC, decide how to distribute the disgorged funds, although the decision typically is made with the aid of a recommendation by the SEC.

During oral argument, Justices on both sides of the political and ideological spectrum voiced their skepticism of the SEC's position that disgorgement is neither a penalty nor a forfeiture and therefore could not be subject to the five-year statute of limitations in § 2462. At times, several Justices appeared flatly unimpressed by the SEC's argument. Justice Elena Kagan, for example, said it seemed "commonsensical" to view disgorgement as deterrence in part, and punishment in part, which would make it a penalty. In particular, Chief Justice John Roberts, Justice Samuel Alito and Justice Anthony Kennedy took issue with the lack of Congressional authorization for civil disgorgement. Chief Justice Roberts and Justice Alito also asked the parties to explain what time limits would apply to disgorgement and where they would come from if § 2462 did not apply. Chief Justice Roberts seemed to scold the attorney for the SEC when he quoted his predecessor, Chief Justice John Marshall, that "it was utterly repugnant to the genius of our laws to have a penalty remedy without limit."

Justice Neil Gorsuch, only in his second day of hearing oral arguments, compared forfeiture in the civil and criminal contexts and questioned why disgorgement would not be subject to a time limit when "the very same remedy" is categorized as a penalty in the criminal system.

### **The Supreme Court's Decision**

While the Justices had their separate issues and questions during oral argument, the Court seemed to be unified in its concern that no statute expressly authorizes the SEC to collect disgorgement in civil actions or defines what SEC disgorgement entails. In an opinion written by Justice Sonia Sotomayor, the Court found that "SEC disgorgement . . . bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not compensate." The Court held that "[t]he five-year statute of limitations . . . therefore applies when the SEC seeks disgorgement." The Justices appeared to be persuaded by the government discretion argument advanced by *Kokesh*. Justice Sotomayor stated that disgorgement is punitive because it is not often not compensatory, with funds either being returned to victims or going to the Treasury.

### **Conclusion**

The *Kokesh* decision is sure to have a negative impact on SEC enforcement efforts, as the agency collects billions of dollars in disgorgement fees every year. The decision will also likely speed up SEC investigations and cause the SEC to file suit more quickly in order to avoid being barred from collecting disgorged profits beyond the five-year limitations period. The SEC may also attempt to secure tolling agreements in cases that could pose a statute of limitations issue.

If you have any questions regarding these issues or any other securities-related matters, please contact one of the authors of this alert or any of the other attorneys in Baker Donelson's Government Enforcement and Investigations or Broker-Dealer/Registered Investment Adviser groups.

