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Report from Washington

Kokesh v. SEC: Supreme Court Considers Whether Five-Year Statute of Limitations Applies to SEC Actions Seeking Civil Disgorgement

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Introduction

The Supreme Court heard oral arguments on April 18, 2017 in *Kokesh v. SEC*, No. 16-529, a case requiring the Court to decide a question with major implications for the remedies the SEC may seek in court: whether civil disgorgement is a "fine, penalty, or forfeiture" governed by a five-year statute of limitations under 28 U.S.C § 2462 or is remedial in nature and therefore not subject to any statute of limitations.

"Chief Justice Marshall said it was utterly repugnant to the genius of our laws to have a penalty remedy without limit . . . the concern, it sees seems to me, is multiplied when it's not only no limitation, but it's something that the government kind of devised on its own."

– Chief Justice Roberts

Since the 1970s, the SEC has frequently sought to require defendants in civil suits for violations of federal securities laws to disgorge the ill-gotten gains of their misconduct. Although Congress has authorized the SEC to seek disgorgement as a remedy in its own administrative proceedings, 15 U.S.C. § 78u–2(e), it has not specifically authorized civil disgorgement outside of that context. Accordingly, there is no statute of limitations specified for civil disgorgement; it remains an implied equitable remedy with parameters determined by the courts.

In the case before the Court, Petitioner argues that the five-year statute of limitations under 28 U.S.C § 2462 should apply to limit actions for civil disgorgement.

Section 2462 states: "Except 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." In 2013, the Supreme Court held, in *Gabelli v. SEC*, 133 S.Ct. 1216, 1224 (2013), that this five-year limitation applies in civil actions seeking penalties from the time a violation of federal securities laws occurred, rather than from when the government knew of or reasonably could have discovered the violation.

Today, application of § 2462 to civil disgorgement actions varies by circuit. The First Circuit held, in 2008, that § 2462 "applies only to penalties sought by the SEC, not its request for injunctive relief or the disgorgement of ill-gotten gains." *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008). The D.C. Circuit reached a similar conclusion in 2010, holding that § 2462 does not apply to civil disgorgement because "disgorgement orders are not penalties, at least so long as the disgorged amount is causally related to the wrongdoing." *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010).

On the other hand, the Eleventh Circuit concluded in 2016 that "forfeiture includes disgorgement," and therefore, "§ 2462 applies to disgorgement." *SEC v. Graham*, 823 F.3d 1357, 1364 (11th Cir. 2016). The Eleventh Circuit's ruling created a circuit split that the Court's decision in *Kokesh* should resolve.

Case Background

In October 2009, the SEC filed a complaint in the District of New Mexico, alleging that from 1995 through 2006, Charles Kokesh, owner of several investment adviser companies, misappropriated funds from business development companies ("BDCs"). Kokesh's investment advisers served as the general partners for those BDCs. *SEC v. Kokesh*, 2015 WL 11142470, at *1. Kokesh allegedly directed the investment advisers' treasurer to use money from the BDCs to pay $23.8 million in salaries and bonuses to officers of the investment advisers, including Kokesh, and to pay $5 million in rent for the investment advisers' offices. *Id.* at *1–2. The SEC also alleged that in 2000, Kokesh initiated $6.1 million in payments, of which he received more than 90%. *Id.* at *2. Those payments were described in SEC reports signed by Kokesh as "tax distributions," even though Kokesh paid only approximately $10,000 in federal taxes in 2000. *Id.*

A jury found Kokesh liable for converting the assets of the BDCs to his own, assisting in defrauding the BDCs, filing false reports with the SEC, and soliciting proxies using false and misleading proxy statements. *SEC v. Kokesh*, 834 F.3d 1158, 1161 (10th Cir. 2016). The district court entered an order enjoining Kokesh from violating certain provisions of the federal securities laws and requiring disgorgement of $34.9 million, which the court found "reasonably approximate[d] the ill-gotten gains causally connected to [Kokesh's] violations." 2015 WL 11142470, at *10.

Kokesh appealed to the Tenth Circuit, arguing that the SEC's claims for disgorgement and the injunction were time-barred by § 2462 to the extent that they accrued more than five years prior to the SEC filing suit. *See* 834 F.3d at 1162. Kokesh first argued that the

injunction was a "penalty" within the meaning of § 2462. *Id.* The Tenth Circuit rejected this argument on the facts of the case. *Id.* at 1163.

Kokesh then asked the Court to find that disgorgement was either a "penalty" or a "forfeiture," and therefore time-barred by § 2462. *Id.* at 1164. Kokesh argued that disgorgement is a penalty "because he is being required to disgorge more than he actually gained himself," including amounts he caused to be paid to the investment advisers' landlord and other officers of the investment advisers. *Id.* Kokesh also argued that disgorgement is a penalty because he would be unable to pay the amount ordered. *Id.* at 1165. The Tenth Circuit rejected these arguments and held that disgorgement is remedial, rather than punitive, because "properly applied . . . [it] does not inflict punishment . . . [it] just leaves the wrongdoer in the position he would have occupied had there been no misconduct." *Id.* at 1164 (internal quotation marks omitted).

Kokesh also contended that disgorgement is forfeiture by another name. *See id.* The court acknowledged that the common meanings of "forfeit" and "disgorge" "capture similar concepts," but cited *Black's Law Dictionary*'s definition of "civil forfeiture": "[a]n *in rem* proceeding brought by the government against property that either facilitated a crime or was acquired as a result of criminal activity." *Id.* at 1165–66 (italics added). The Tenth Circuit also noted that "civil fine" and "penalty" as used in § 2462 are "undoubtedly punitive." *Id.* Therefore, the court held, Congress intended § 2462 to apply to the "historical," punitive definition of forfeiture, whereby property could be seized even if its owner was innocent of wrongdoing and the value of the property had no relation to the loss or gain. *Id.* According to the court, that definition does not encompass disgorgement. *Id.*

"[T]he way the SEC has used [disgorgement], is that it's trying to do a lot of things. It's trying to compensate. It's trying to deter. It's trying, to some extent, to punish misconduct."

– Justice Kagan

Finally, the Tenth Circuit stated that it was obligated to "construe § 2462 in the government's favor to avoid a limitations bar" and that it "should not strain to expand the meaning of the statute's language to restrict the government." *Id.* at 1166–67.

On January 13, 2017, the Supreme Court granted Kokesh's petition for a writ of certiorari on the question of whether § 2462's five-year statute of limitations applies to claims for disgorgement.

Oral Argument Highlights

The oral argument focused on each party's claims that disgorgement is or is not a "penalty" or "forfeiture" under § 2462. Petitioner argued that the Court should apply the ordinary definition of "forfeiture," as opposed to the Tenth Circuit's historical definition. According to Petitioner, a forfeiture is "an order requiring turnover of money or property to the

government as a result of wrongdoing," encompassing civil disgorgement. Petitioner also contended that remedies containing both remedial and punitive elements should be considered penalties. In Petitioner's view, the purpose of disgorgement is to impose consequences on a defendant as a result of wrongdoing and, therefore, to punish the defendant. Petitioner suggested that disgorgement is punitive because it may require a defendant to disgorge funds that the defendant never actually possessed, but caused to be given to others. Additionally, Petitioner argued that disgorgement is not categorically remedial or compensatory because disgorged funds are not distributed to victims except at the discretion of the government.

The U.S. government, however, urged the Court to construe each word of § 2462 narrowly and to find that civil disgorgement is neither a "penalty" nor a "forfeiture." The government argued that disgorgement is not a penalty because it is intended only to remedy unjust enrichment and put a defendant back where they would have been had they committed no wrongdoing. According to the government, penalties and forfeitures may require a person to give up something to which they are rightfully entitled, but disgorgement only deprives a person of money to which they never had any rightful entitlement. The government also argued in response to Petitioner that discretion over distribution of disgorged funds actually lies with courts, not the government. According to the government, a court ultimately decides whether to require disgorgement and how to distribute disgorged funds, though the SEC may make a recommendation.

During oral argument, the Justices asked many questions and posed several hypotheticals to test the parties' definitions of "penalty" and "forfeiture" and to better understand the actual use and implications of civil disgorgement. For example, Justice Sotomayor posed a hypothetical to Petitioner in which she committed a crime but gave half of the proceeds to Justice Breyer, asking whether it would be a penalty to require her to disgorge the full amount. Justice Kennedy posed a similar hypothetical involving a person who misappropriated $100,000 and gave $90,000 to a co-conspirator. Justice Kennedy then asked whether the government could recover a total of $190,000 from the co-conspirators and whether that could be called disgorgement. Justice Breyer asked the government to list characteristics of disgorgement shared by neither fines nor forfeitures. He also likened the government's argument to claiming that a houseboat should not be subject to a tax imposed by a city on both houses and boats. Chief Justice Roberts asked either party to tell him in what percentage of civil disgorgement cases the funds were actually distributed to victims.

Chief Justice Roberts, Justice Alito, and Justice Kennedy asked both parties multiple times about a 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 does not apply. Chief Justice Roberts quoted Chief Justice Marshall to say that it is "utterly repugnant" to our laws to have a penalty remedy without a time limit.

Justice Gorsuch, in his second day hearing oral arguments, questioned both parties repeatedly about comparisons between criminal law and the case at hand. He suggested that criminal forfeiture is considered punitive, even though forfeited funds are sometimes distributed to victims just as with civil disgorgement. He also asked both parties whether the difference between criminal and civil remedies is simply their label.

"[W]hen we get to the criminal context, this very same remedy of disgorgement of everything is often called a forfeiture, and it is a penalty; right? So why does it make a difference that we just happen to be in the civil context?"

– Justice Gorsuch

Justice Kennedy suggested that although both parties argued in favor of a categorical rule applying to all civil disgorgement claims, the Court might do best to eschew such a broad rule and instead give guidance as to when civil disgorgement is a penalty and when it is not.

Potential Implications

A significant majority of the SEC's enforcement actions are brought well within the limitations period contemplated by § 2462 such that an adverse ruling for the SEC would not meaningfully affect the agency's mainstream enforcement program. An adverse ruling would, however, have a significant impact on the SEC's ability to pursue aggressive theories of disgorgement in the relatively narrow class of cases – like long-running and well-concealed Ponzi schemes – that often take years to come to light. An adverse ruling may also impose more discipline and restraint on the SEC's efforts to retroactively target conduct that had historically been viewed as appropriate within a given industry, as has been the case with the SEC's recent actions against private equity advisers. More broadly, should the SEC suffer a setback, expect to see renewed focus by the Staff on securing tolling agreements in all cases that could involve possible statutes of limitations issues, as well as renewed emphasis on streamlined investigative techniques. The Court could also strike a middle ground, holding that disgorgement is sometimes a penalty, as when disgorged funds are kept by the government, and sometimes not, as when disgorged funds are disbursed to victims of a defendant's wrongdoing. Such a ruling, however, could lead to confusion and unnecessary expense in future cases. The distinction would potentially require courts to wait until suits are fully resolved and remedies granted before determining whether actions should have been time-barred to begin with.

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