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Reflections on *Kokesh v. SEC*

Potential Ramifications of SEC Disgorgement Being a Penalty Part One of a Two-Part Article

By Dixie L. Johnson and M. Alexander Koch

In the period since the Supreme Court's unanimous decision in *Kokesh v. SEC*, No. 16-529, 2017 WL 2407471 (U.S. June 5, 2017), which rejected the Securities and Exchange Commission's (SEC) longstanding position that disgorgement was an equitable remedy not subject to the five-year statute of limitations in 28 U.S.C. § 2462, many have commented about the increased need for the SEC's enforcement attorneys to complete their investigations quickly, and the frustration that hidden ill-gotten gains would never be recovered due to the five-year limit. These are important and valid ramifications, and we include them in this article.

But the *Kokesh* decision raises other potential consequences that have not been as widely noted. We address these other potential consequences in a two-part article. Part One, herein, addresses the following questions:

- Does the five-year statute of limitations apply to SEC administrative actions?
- Will the five-year statute of limitations hinder SEC enforcement?
- Will the SEC tie cooperation credit to prompt action?
- Can the SEC continue to obtain disgorgement?
- Can the SEC continue to obtain pre-judgment interest on disgorgement amounts?
- Can the SEC continue to obtain disgorgement from relief defendants?

In our second installment, we will address whether defendants and respondents can still seek indemnification or insurance coverage for disgorgement and pre-judgment interest, if disgorgement paid to the government is deductible for U.S. federal tax purposes, and whether those who paid disgorgement to the SEC for conduct outside the five-year statute of limitations period can recoup that portion of their payment.

The SEC's Enforcement Action and the Supreme Court's Opinion in *Kokesh*

The relevant facts and case history are straightforward. The SEC filed its civil action against Charles Kokesh, the owner of two investment advisers that counseled business development companies, in October 2009. The Commission alleged that between 1995 and 2009, through his firms, Kokesh violated antifraud and other provisions of the federal securities laws by misappropriating $34.9 million from business development companies and causing the filing of "false and misleading SEC reports and proxy statements."

After a jury verdict in the SEC's favor, the court ordered Kokesh to pay a $2,354,593 civil monetary penalty, $34.9 million in disgorgement, and $18.1 million in prejudgment interest, calculated based on the disgorgement amount. The district court applied the 28 U.S.C. § 2462 five-year limitations period to the civil monetary penalty, but agreed with the Commission that the statute of limitations did not apply to disgorgement because it was not a "penalty."

On appeal, Kokesh argued that the disgorgement amount should have been only $5 million because the five-year statute of limitations in § 2462 also applied to disgorgement. But the U.S. Court of Appeals for the Tenth Circuit upheld the district court. The Tenth Circuit's opinion, which reflected the majority view among federal courts, created a split with the U.S. Court of Appeals for the Eleventh Circuit's decision in *SEC v. Graham*, 823 F.3d 1357, 1363 (11th Cir. 2016) (holding that disgorgement is a "forfeiture" under § 2462). The Supreme Court subsequently granted certiorari to resolve the circuit split.

The Supreme Court unanimously and unambiguously reversed the appellate

M. Alexander Koch and **Dixie L. Johnson** are partners in the Special Matters and Investigations group of King & Spalding LLP. Ms. Johnson co-leads the firm's Securities Enforcement and Regulation practice. Mr. Koch specializes in defending public companies, regulated entities, and individuals in government investigations, with a particular focus on securities enforcement.

decision. Although the Court could have ruled narrowly by ruling that disgorgement as applied in this case constituted a penalty, it took a different approach by ruling much more broadly: "We hold that SEC disgorgement constitutes a penalty." The Court also held that "the 5-year statute of limitations in §2462 therefore applies when the SEC seeks disgorgement."

The Court determined that three principles demonstrated that SEC disgorgement is a penalty within the meaning of § 2462.

- First, SEC disgorgement is imposed as a consequence for violations where the victim is the public at large, rather than an aggrieved individual.
- Second, SEC disgorgement's primary purpose is to deter future violations, which is inherently punitive.
- Third, SEC disgorgement does not directly compensate victims, because a court has discretion over whether disgorged funds will be distributed to harmed investors or transferred to the U.S. Treasury. As a result, the Court held, "[w]hen an individual is made to pay a noncompensatory sanction to the Government as a consequence of a legal violation, the payment operates as a penalty."

The Court dismissed the Commission's argument that disgorgement is "remedial." Because SEC disgorgement sometimes exceeds profits, the Court found that disgorgement in such cases "does not simply restore the status quo … [but] leaves the defendant worse off." For example, the opinion noted that SEC disgorgement may not consider defendants' expenses that reduced illegal profits, and courts have ordered insider trading tipper defendants to disgorge the profits of their tippees, even though the tippers never received any profits. Thus, according to the Court, SEC disgorgement is not a remedy that simply returns defendants to their prior position, but rather goes beyond and *penalizes* defendants for their conduct.

The Potential Ramifications Of *Kokesh*

Most commentators have focused on the five-year limitations period, which certainly carries important ramifications for the SEC. But as we describe here, the Supreme Court's ruling that "SEC disgorgement constitutes a penalty" has more far-reaching ramifications.

Does the Five-Year Statute of Limitations Apply to Administrative Actions?

The *Kokesh* holding arose in the context of a federal court case, but the holding broadly applies to "SEC disgorgement." Because the remedy has been consistently applied in both federal courts and the SEC's own administrative courts, and because courts have held that § 2462 applies in SEC administrative proceedings, there is little doubt that the five-year limitations period would apply equally in administrative proceedings as well as in federal court.

Will the Five-Year Statute of Limitations Hinder SEC Enforcement?

The five-year statute of limitations will not impact the SEC in most cases because the Commission typically acts, or preserves claims, within five years of the misconduct.

Where misconduct does not come to light until well after it occurred, however, or where investigations are inherently time-consuming, the SEC's hands may now be tied. These include matters involving the Foreign Corrupt Practices Act (FCPA), long-running Ponzi and pyramid schemes, accounting fraud, or investigations requiring the staff to gather information through time-consuming requests to foreign regulators.

In those types of matters, we expect that the SEC enforcement staff may now move more aggressively, be less willing to agree to extensions for the production of documents and scheduling of testimony, and focus on fewer lines of inquiry in their investigations. We also expect that the staff will more routinely ask entities and individuals under investigation to enter tolling agreements, and will do so at an earlier stage of the investigation than has been customary in the past.

Will the SEC Tie Cooperation Credit to Prompt Action?

Since at least 2001, the SEC has expressly included promptness (in self-reporting, volunteering evidence, and responding to the SEC's requests) as factors in evaluating the extent to which cooperation credit should be awarded in enforcement settlements. These promptness factors may become more prominent to the SEC's assessment of cooperation in the wake of *Kokesh*, because this will maximize the potential remedies available to the SEC. For better or for worse, we expect that this dynamic will make the already difficult analysis of whether or when to self-report potential violations and cooperate with the SEC even more complex. As one example, *Kokesh* adds to the considerations companies must evaluate in deciding whether or when to self-report conduct taking place at or near the five-year statute of limitations period.

Can the SEC Continue to Obtain Disgorgement?

As it considers the impact of *Kokesh*, we expect that the SEC staff will be less aggressive in its disgorgement demands and more open to arguments limiting how disgorgement is calculated. At the same time, defendants and respondents who litigate will undoubtedly follow up on the Supreme Court's apparent invitation, in a footnote, to challenge whether disgorgement is available *at all* as an SEC remedy in enforcement actions. Footnote three states:

> Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to § 2462's limitations period.

At least two amicus briefs submitted in connection with the *Kokesh* case argued that, if disgorgement is not an equitable remedy, then the SEC has no statutory authority to seek disgorgement, at least in district court cases. Furthermore, four different justices asked questions or made comments about the issue during oral arguments, including Chief Justice Roberts' remark that, "One reason we have this problem is that the SEC devised this remedy or relied on this remedy without any support from Congress. If Congress had provided, here's a disgorgement remedy, you would expect them, as they typically do, to say, here's a statute of limitations that goes with it."

The question might not have arisen if the SEC had not expanded the original concept of disgorgement and had not touted it as a deterrent for violations by others. As the Court recounted in *Kokesh*, courts have awarded disgorgement in SEC actions since the 1970 *Texas Gulf Sulphur* case, which held that courts could order defendants to disgorge ill-gotten gains as "an exercise of their 'inherent equity power to grant relief ancillary to an injunction.'" The defendants in *Texas Gulf Sulphur* were company insiders who purchased, or tipped others to purchase, company stock based on material non-public insider information. Defendants were ordered to pay "restitution" of their own illicit trading profits to the company, and one defendant was ordered to pay "restitution for the profits derived by his tippees." *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971) ("We conclude that the requirement of restitution in this case was a proper exercise by the trial judge of the district court's equity powers.").

The SEC took that ill-gotten gains concept and ran with it for decades, making disgorgement a standard remedy in enforcement cases. The concept became so ingrained that, in 1990, Congress specifically authorized the SEC to seek civil penalties in district court proceedings, and gave the SEC the express authority to seek disgorgement in administrative proceedings, but did not add statutory authority for disgorgement in district court proceedings. Similarly, in the 2002 Sarbanes-Oxley Act, Congress added language to the Exchange Act stating that the SEC "may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors," but again did not expressly include disgorgement by federal courts in the statute. The legislative histories of both laws demonstrate that, because *Texas Gulf Sulphur* confirmed that disgorgement was part of a federal court's inherent equitable powers, Congress did not see a need to provide federal courts with express authority to order disgorgement.

Meanwhile, over time, the SEC argued, and courts accepted, that disgorgement had a deterrence objective. *See, e.g., SEC v. First Jersey Securities, Inc.*, 101 F.3d 1474 (2d Cir. 1996), cert. den., 522 U.S. 812 (1997) ("The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws."). The SEC also aggressively expanded the boundaries of disgorgement beyond a defendant's personal illicit gains. For example, the SEC recently has been successful in holding a portfolio manager liable for disgorging the illicit gains made by the fund he managed based on his insider trading, *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014), and holding a stock seller jointly and severally liable for the proceeds of a pump and dump scheme, even though he transferred some of the profits to other participants in the fraud, *SEC v. Whittemore*, 659 F.3d 1 (D.C. Cir. 2011).

Now that the Court has ruled that SEC disgorgement is not an equitable remedy, and has appeared to invite a challenge to the question of whether the SEC has any basis to seek disgorgement as a remedy, defendants no doubt will press the issue. Furthermore, because the maximum amount of penalties is limited by statute, we expect defendants to argue that the SEC cannot impose a penalty (including disgorgement) greater than that statutory limit. For example, under Exchange Act § 21(d)(3), the SEC is entitled to obtain penalties in civil actions that do not exceed either the greater of a maximum dollar amount per violation or the defendant's gross pecuniary gain as a result of the violation. Up until now, it has been common for the staff to seek substantial penalties under this provision in addition to full disgorgement of the defendant's illicit gains.

Following *Kokesh*, however, defendants may argue that such a monetary remedy would be impermissible because the combination of disgorgement and traditional civil penalty would exceed the maximum statutory penalty. To avoid such an argument, the SEC might choose to proceed in its own administrative forum, where the availability of disgorgement is expressly authorized by statute. In response, defendants likely would argue that the SEC should not be able to circumvent *Kokesh* through its choice of forum, and that total monetary remedies should not exceed the maximum available statutory penalty, regardless of whether the case is brought as a civil action or administrative proceeding.

Expected Action from the SEC

To address this fundamental challenge to its enforcement program, we expect that the SEC may take action in one or more of the following ways, none of which is ideal from the SEC's perspective.

First, the Commission could define disgorgement more narrowly as restitution to the victims of the illegal conduct, in keeping with the original holding of *Texas Gulf Sulphur* and therefore more in line with the traditional equitable powers of federal courts. Renaming the remedy to clarify that it is different from the "SEC disgorgement" analyzed by the Court, and removing it from deterrence rhetoric, could help clarify that this is remedial, not a penalty.

In this regard, it is notable that on the same day that Justice Sotomayor delivered the Court's unanimous opinion in *Kokesh*, she also authored a unanimous opinion finding that the criminal forfeiture statute did not allow a defendant to be held jointly and severally liable for property that his co-conspirator derived from the crime, but which the defendant himself did not acquire. *Honeycutt v. United States*, No. 16-142, 2017 WL 2407468 (U.S. June 5, 2017). Taken together, the decisions signal a clear desire by the Court to rein in the government's more aggressive theories of monetary remedies.

Second, the SEC could back away from seeking disgorgement in district court actions, and instead focus on seeking higher penalties where authorized by statute, in order to make up the difference in overall monetary remedies. Given concomitant pressure on corporate penalties, which may injure shareholders a second time after the violation injured them the first time, this could raise additional challenges for the Enforcement Division.

Third, the SEC could seek a legislative fix from Congress, although obtaining that fix may be unlikely in the current political climate.

Finally, the SEC could turn to filing more cases as administrative proceedings, where it arguably has express statutory authority to seek disgorgement. While this may work for settled matters, it will create its own challenges for the SEC to turn to this option for litigated matters when it already is facing heavy criticism for using administrative proceedings to benefit from its purported "home court" advantage and where the very authority of the ALJs is under attack.

Can the SEC Continue to Obtain Pre-Judgment Interest on Disgorgement Amounts?

In every case involving disgorgement, whether filed in federal court or administratively, it is the SEC's practice to seek pre-judgment interest, calculated at the IRS underpayment rate. In contrast, the SEC does not seek pre-judgment interest on civil penalty amounts. Federal courts typically have held that requiring the payment of prejudgment interest on disgorgement was appropriate as an equitable remedy to deprive the wrongdoer of the benefit of holding the illicit gains over time by approximating the cost of borrowing the funds. Now that "SEC disgorgement constitutes a penalty," it is not at all clear that the SEC has the authority to obtain pre-judgment interest in cases filed in federal court. The SEC may have a stronger argument in administrative proceedings, where it has express statutory authority to seek disgorgement and has promulgated a rule concerning the recovery of prejudgment interest.

Can the SEC Continue to Obtain Disgorgement from Relief Defendants?

Similarly, the SEC frequently seeks to recover disgorgement from "relief defendants," third parties that did not engage in wrongdoing, but have received illicit gains resulting from violations committed by others and have no legitimate claim to the funds. As recently stated by the U.S. Court of Appeals for the Second Circuit, "[e]quitable relief against a third-party non-wrongdoer may be entered where such an individual (1) has received ill-gotten funds; and (2) does not have a legitimate claim to those funds." *SEC v. Miller*, 808 F.3d 623, 635 (2d Cir. 2015). Courts typically have viewed such requests to be within their equitable authority, but in the wake of *Kokesh's* holding that disgorgement is a penalty, it is not clear that the SEC will be able to obtain disgorgement from non-wrongdoers.

Conclusion

While at first blush the *Kokesh* opinion seems relatively straightforward, the Court's ruling raises a number of complicated legal and strategic questions, and we will explore more of these potential ramifications in our second installment. It will take time to see how these issues play out, but entities and persons who face an SEC investigation or previously were the subject of an SEC enforcement action should consider consulting counsel to assess whether the decision impacts their rights and obligations.

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