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Expert Analysis

SEC's View on Statute of Limitations Faces Another Test

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The SEC has sought ways to avoid the broad application of the so-called "fallback" five-year statute of limitations since federal courts began applying it to SEC enforcement actions in 1996.[1] In 2013, the Supreme Court rejected the agency's attempts to extend the five-year period by utilizing the fraud discovery rule to toll the statute until the SEC "discovered" the misconduct. The SEC also consistently has asserted that no statute of limitations applies to actions seeking equitable relief, which the agency insists includes claims for disgorgement. Last month, the court granted certiorari in *Kokesh v. SEC*, 834 F.3d 1158 (10th Cir. 2016), to settle the issue of whether the five-year statute of limitations applies to the SEC's ability to recoup disgorgement.

Setting the table for Supreme Court review, federal courts that have considered the issue disagree on the essential nature of the disgorgement remedy. Specifically, courts differ on whether disgorgement is a punitive remedy, intended to punish a defendant, and, therefore, covered by the five-year limitations period established by §2462 of Title 28, or an equitable remedy that seeks the return of illegal profits and, therefore, falls beyond the statute. Given the SEC's increasing reliance on civil disgorgement actions to secure financial recoveries and the expansive breadth of rulings delineating what a defendant can be required to disgorge, the Supreme Court's decision will have a significant impact on the SEC's enforcement practice and defendants' financial exposure in such cases. *Kokesh* exemplifies how high the stakes of the court's decision can be—more than 85 percent of the disgorgement sought by the SEC in that case falls outside the five-year statutory limit.

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Limitations Statutes and the SEC

Limitations statutes exist to insure that the passage of time does not result in lost evidence or faded memories and are a reflection of the legislative view that a time comes when a potential defendant "ought to be secure in his reasonable expectation that the slate has been wiped clean of ancient obligations." *3M Co. v. Browner*, 17 F.3d 1453 (D.C. Cir. 1994) (internal citations omitted). In applying §2462 to administrative actions, courts have ruled that these fundamental notions apply with equal force to agency actions as they do to judicial actions. Id.

Failing in its initial position that §2462 does not apply to any SEC action, the agency then sought refuge in the discovery doctrine to delay the accrual of a claim until the violation at

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issue is discovered. In 2013, in *Gabelli v. SEC*, the Supreme Court rejected that argument, ruling that the SEC was required to bring enforcement actions seeking penalties against individuals for securities laws violations within five years of the date the alleged wrongdoing was committed, regardless of when the SEC "discovered" the conduct. 133 S. Ct. 1216 (2013). Given the agency's "central mission" to investigate and root out such violations, the court found the SEC did not need the benefit afforded by the fraud discovery rule to private litigants and declined to graft such a rule onto §2462. In its ruling, the court declined to consider whether §2462 also applied to disgorgement claims filed by the SEC.

Relying on this gap in the case law, the SEC consistently has taken the position that §2462, which by its text applies to "any action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture," does not apply to disgorgement claims. The SEC reasons "disgorgement" is an equitable remedy intended to prevent unjust enrichment, distinguishable from the punitive sanctions listed in the statute. A number of federal district courts and the U.S. Courts of Appeals for the First and D.C. Circuits have agreed with the SEC. Those courts reason that disgorgement orders are not penalties as "long as the disgorged amount is causally related to the wrongdoing," *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010), and is seeking to restore only "ill-gotten gains." *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008).

In May 2016, the Eleventh Circuit took the opposite view. In *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016), that court found disgorgement, defined by Black's Law Dictionary as "[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion," to be a subset of forfeiture, which "occurs when a person is forced to turn over money or property because of a crime or wrongdoing." The court stated: "We find no indication that in enacting §2462's widely applicable statute of limitations, Congress meant to adopt the technical definitions of forfeiture and disgorgement the SEC urges over the words' ordinary meanings."

> The Supreme Court's decision in 'Gabelli' made clear that allowing an "indefinite" period for penalty liability in enforcement actions was unfair. Allowing the SEC a similarly unlimited time to seek disgorgement pursuant to expansive theories in sums that often may bankrupt a defendant is similarly unjust.

'Kokesh v. SEC'

In August 2016, a few months after the Eleventh Circuit decided *Graham*, the Tenth Circuit issued its decision in *SEC v. Kokesh*, adopting the position of the First and D.C. Circuits. The SEC filed its civil enforcement action against Charles R. Kokesh in 2009, alleging that Kokesh violated the federal securities laws from 1995 through 2006 through two SEC-registered investment-adviser firms he owned and operated. Pursuant to contracts, the adviser firms conducted the day-to-day operations of four business development funds. The SEC alleged that Kokesh misappropriated substantial sums from the funds to pay operating expenses of the adviser firms, including salaries and bonuses to himself, in violation of the terms of those contracts. After the jury rendered a verdict in the government's favor, the SEC moved for entry of judgment, asking the district court to impose a civil monetary penalty of $5 million and disgorgement of $34.9 million. Notably, the SEC concedes that $29.9 million of this amount is attributable to gains from before the five-year limitations period.

Kokesh argued that the government only could seek disgorgement for activities that occurred since 2004, in the five years prior to the suit being filed, relying on the District Court for the Southern District of Florida decision in *SEC v. Graham*, which had not yet reached the Eleventh Circuit. Kokesh asserted that disgorgement was a penalty akin to forfeiture, a remedy specifically contained in the text of §2462. The district court in *Kokesh* found that Tenth Circuit precedent foreclosed the argument and ordered disgorgement of the full $34.9 million, plus an additional $18 million in prejudgment interest.

The Tenth Circuit affirmed, holding that a disgorgement order is neither a penalty nor forfeiture within the meaning of §2462. According to that court, despite its deterrent effect, disgorgement is not a penalty because it does not inflict punishment. Instead, it is a remedy intended only to "depriv[e] the wrongdoer of the benefits of wrongdoing." In considering whether disgorgement was the equivalent of forfeiture, the Tenth Circuit took the view that §2462 used the term "forfeiture" in a "narrow" "historical sense" limited to the taking of tangible property used in criminal activity.

In his petition for certiorari, Kokesh renews the arguments he made to the trial and circuit courts, asserting that the Eleventh Circuit has it right in *Graham* and that disgorgement is both punitive and synonymous with forfeiture as contemplated under §2462. Kokesh asserts that disgorgement "is a monetary judgment, payable to the government, that is premised on a judicial finding that *the law was violated*: a quintessentially punitive remedy."[2] Kokesh notes that since *Gabelli*, the SEC increasingly has relied on disgorgement to maximize recoveries that were otherwise limited by the five-year limitations statute. Statistics show that disgorgement payments have risen 60 percent since 2011, while penalty payments have increased only 25 percent. Further, in 2015, the SEC collected $3 billion in disgorgement payments.

The agency's ability to amass such large recoveries in disgorgement claims is attributable in large part to the breadth of activity to which disgorgement can apply. Courts commonly require defendants to disgorge funds that they never possessed, but that instead went to unrelated third-parties, so long as those funds can be traced to the alleged violation. Further, according to Kokesh, "[t]he amount of disgorgement need not be proven, but rather can be only a 'reasonable approximation of profits causally connected to the violation.'" Accordingly, disgorgement is a powerful weapon in the SEC's arsenal.

Kokesh's case is a perfect example of the impact of the SEC's aggressive use of the disgorgement remedy. The $34.9 million disgorgement sought by the SEC covers a period of 15 years. The parties agree that at least $17.6 million of this amount reflects funds that went not to Kokesh himself, but to third parties to whom Kokesh was not related. Further, if the five-year statute of limitations were applied, the $34.9 million disgorgement judgment would be reduced to $5 million. Given that the $34.9 million disgorgement judgment far exceeds the gains he received, Kokesh asserts that he likely could never pay the disgorgement judgment and would be rendered insolvent "with no prospect of recovering."

In its brief submission to the court, the SEC agrees that the issue is ripe for review and is "important to the administration of the securities laws."[3] Addressing the merits of the Tenth Circuit's decision, the agency reiterates its position that disgorgement is distinct from damages, penalties, and forfeiture, and that the purpose of disgorgement is not punitive.

Conclusion

In its amicus brief in support of Kokesh's position, the U.S. Chamber of Commerce notes that "[b]asic fairness demands that the liability risk posed by these potentially astronomical awards have an expiration date." The Supreme Court's decision in *Gabelli* made clear that allowing an "indefinite" period for penalty liability in enforcement actions was unfair. Allowing the SEC a similarly unlimited time to seek disgorgement pursuant to expansive theories—particularly in situations like those presented in *Kokesh* where the SEC for years seemed unconcerned with the conduct at issue—in sums that often may bankrupt a defendant is similarly unjust.

1. See *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996); rehearing denied (Aug. 28, 1006); see also *Gabelli v. SEC*, 13 S. Ct. 1216, 1219 (2013) (Supreme Court noting application of five-year limitations to SEC claims for penalties).

2. Petition for Writ of Certiorari, *Kokesh v. SEC*, No. 16-529 at pp. 25-26 (Oct. 18, 2016) (emphasis in original).

3. The SEC argued that it was impeded by the Eleventh Circuit's decision in *Graham* in the sense that it cannot pursue full disgorgement remedies to which it believes it is entitled in states within that circuit. Brief for the Respondent, *Kokesh v. SEC*, No. 16-529 at 11 (Dec. 9, 2016).