Legal Backgrounder

Vol. 32 No. 5 March 10, 2017

Washington Legal Foundation
Advocate for Freedom and Justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302 wlf.org

Is the Clock Running out on SEC's Unchecked Pursuit of Disgorgement Penalties?

by Andrew J. Morris

F. Scott Fitzgerald told us that we are borne back ceaselessly into the past.[1] The Securities and Exchange Commission agrees: No matter how many years go by, it claims, long-ago conduct remains fair game for an SEC disgorgement action.

Defendants have contested the Commission's extraordinary claim by citing § 2462, which imposes a five-year limitation on enforcement actions seeking a "fine, penalty, or forfeiture." 28 U.S.C. § 2462. SEC has responded that these three words do not encompass disgorgement, so that § 2462 does not apply.

Soon the US Supreme Court will decide who is right. It granted *certiorari* in a US Court of Appeals for the Tenth Circuit case, *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016), to resolve a split between that circuit, which held that § 2462 does not apply to disgorgement, and the Eleventh Circuit, which held that it does, *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016).[2] This Legal Backgrounder explains why the Court should hold that § 2462 applies to disgorgement actions.[3]

The Issue and the Billions of Dollars at Stake

SEC enforcement actions typically seek disgorgement and monetary penalties. Both categories involve huge sums of money, but disgorgement involves far more: In 2015, SEC obtained about $1.2 billion in penalty orders and $3 billion in disgorgement orders.[4] Other agencies also obtain large disgorgement (and penalty) awards—such as the $1.2 billion in disgorgement the Federal Trade Commission recently obtained in a single antitrust matter.[5]

SEC often brings disgorgement actions many years after the underlying events. In *Kokesh*, the violations extended back 13 years, and the court ordered disgorgement of $35 million. 834 F.3d at 1160. The court also ordered penalties of about $2 million, but it limited those to the five-year period in § 2462. *Id*. at 1160.

---

[1] F. Scott Fitzgerald, The Great Gatsby 153.

[2] In two earlier decisions, two circuits have held that § 2462 does not apply to disgorgement actions. *See Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010); *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008).

[3] Ed. Note: WLF filed an *amicus* brief in support of Kokesh, *available at* http://www.wlf.org/upload/litigation/briefs/16-529tsac-WashingtonLegalFoundation.pdf.

[4] SEC, Select SEC and Market Data Fiscal 2015, at 2.

[5] *FTC v. Cephalon, Inc.*, No. 2:08-cv-2141 (E.D. Pa. June 17, 2015).

Andrew J. Morris is a Partner with the law firm Morvillo LLP.

This disgorgement sanction was large because, in addition to counting so many years of violations, the court permitted SEC to expand "disgorgement" far beyond its ordinary meaning. In ordinary usage, disgorgement refers only to the surrender of ill-gotten gains, a measure that seems intuitively reasonable. But the disgorgement sanction in *Kokesh* exceeded the defendant's gains by more than $17 million, because the court also included all benefits that accrued to any third party due to the defendant's violations—here including salaries and rent that the defendant's company paid to unrelated parties. 834 F.3d at 1161, 1164-65. This novel expansion of so-called disgorgement increases the stakes in the Supreme Court's decision as to whether § 2462 limits these actions.

The Supreme Court's Framework for Interpreting § 2462

So does § 2462 apply to SEC disgorgement actions? The Supreme Court provided the framework to answer this question in *Gabelli v. SEC,* 133 S. Ct. 1216 (2013). Issued just four years ago, *Gabelli* was a forceful opinion from a unanimous Court. It established that § 2462 should be construed broadly, to advance the purpose of limitation provisions in the specific context of SEC enforcement actions for money sanctions.

Gabelli addressed an SEC action for statutory penalties. The action undisputedly was covered by § 2462's reference to "penalties," but SEC cited the "discovery rule" and argued that the clock did not begin to run until SEC discovered the violation. The discovery rule, the Supreme Court explained, was created to assist fraud victims who had not immediately known they were defrauded, and who—being private citizens—had not actively investigated that possibility. 133 S. Ct. at 1222-23.

The Court's discussion set out guiding principles for interpreting § 2462. In particular, the Court distinguished between two kinds of legal proceedings: compensation proceedings, where a party who caused an injury makes a payment to the injured victim to compensate for the injury; and enforcement proceedings, where the government requires a payment because a defendant violated a public law. *Id*. at 1221-24. Essentially because SEC's penalty action lay on the "enforcement" side of this divide, the Court concluded that the discovery rule did not apply. *Id*. at 1224.

The Court gave several interrelated reasons. First, the plaintiff in *Gabelli* was not a private citizen; the plaintiff was SEC, whose "central mission" is "to investigate potential violations of the securities laws." *Id*. at 1222 (internal quotation marks and citations omitted). It followed that Congress did not intend to extend the limitations period to permit SEC more time to investigate. *Ibid*. Second, SEC was not a plaintiff that was seeking compensation (for itself or anyone else), so there was no compensation interest that might have led Congress to extend the limitations period. *Id*. at 1223. That left only, third, the long tradition of imposing time limits on enforcement actions for money sanctions. Here the Court emphasized the importance of protecting defendants from exposure to government enforcement action for an "uncertain period into the future." *Ibid* (internal quotations marks and citation omitted). The court then concluded that Congress did not intend to extend the limitations period indefinitely, as SEC had advocated. *Ibid*.

Why § 2462 Applies to Disgorgement Actions

Gabelli did not address disgorgement actions, but its principles all but establish that disgorgement in SEC actions is both a penalty and a forfeiture. Disgorgement is a penalty because it serves a penal function. *Gabelli* summarized the case law to tell us what makes an action penal in nature. An action is "intended to punish," the Court explained, where it (i) involves a "different kind of plaintiff"—an enforcement agency rather than an injured party, *and* (ii) "seeks a different kind of relief"—not to compensate an injured party, but to sanction a wrongdoer for violating a public law. 133 S. Ct. at 1223. SEC disgorgement actions meet both these conditions.

Disgorgement also is a forfeiture, because under *Gabelli*'s natural-reading approach, disgorgement is synonymous with forfeiture. The Supreme Court indicated this in a 1996 discussion of forfeiture, where it stated that "forfeiture ... requires disgorgement of the fruits of illegal conduct." *United States v. Ursery*, 518 U.S. 267, 284 (1996).

These natural readings neatly advance the purpose of limitation statutes, beginning with providing closure to defendants. And there is no reason to think that, in Congress's view, this usual purpose did *not* apply to disgorgement actions. Recall that *Gabelli* explained the kind of special circumstances where Congress might have intended such a special, extended limitations period: where the plaintiff is (i) an injured party (ii) who seeks compensation, and (iii) who deserves more time to do its investigating. But these special circumstances do not apply to SEC disgorgement actions.

The Circuit Split

After the Supreme Court decided *Gabelli*, the Eleventh and the Tenth Circuits issued opposing decisions on disgorgement.

The Eleventh Circuit correctly concluded that § 2462 applies. In May of last year, the Eleventh Circuit issued *Graham*, correctly concluding that § 2462 covers actions for disgorgement. Giving the words their natural meaning, the court found "forfeiture" clearly synonymous with disgorgement. *Graham*, 823 F.3d at 1363. It saw no need to consider whether disgorgement also is a penalty. *Id. at* 1363 n.3.

The Tenth Circuit's decision in* Kokesh *is inconsistent with* Gabelli *and should not be followed. Three months later, the Tenth Circuit issued *Kokesh*, disagreeing with *Graham* and concluding that disgorgement is not covered by § 2462. The court could reach this outcome only because, remarkably, its opinion never even mentioned *Gabelli*. To the contrary, from the start the court took a tack that ignored *Gabelli*'s guidance.

The differences began with *Kokesh*'s approach to interpretation. The court construed § 2462 "in the government's favor to avoid a limitations bar," 834 F.3d at 1166, and did so "to protect the public from the negligence of public officers in failing to timely file claims in favor of the public's interests." *Id*. at 1162.

This pro-government presumption is, to say the least, *not* the Supreme Court's approach to § 2462. *Kokesh* rested its presumption on two decisions that are inapposite because they addressed the government as a contractual party in the marketplace, not as an enforcement authority.[6] And *Kokesh*'s justification for its approach—giving the government more time to investigate—is one *Gabelli* already rejected in the specific context of § 2462. Where *Kokesh* gave the SEC perpetual authority just in case SEC employees were negligent in carrying out their duties, *Gabelli* specifically refused SEC's request for more time to investigate. This is where *Gabelli* stressed that conducting investigations is, after all, SEC's "central mission." 133 S. Ct. at 1223.

Kokesh's interpretive approach went further awry when the court adopted narrow, highly artificial definitions of the key words—instead of following *Gabelli*'s lead by giving the words their natural reading. *Kokesh* also ignored *Gabelli*'s basic distinction between compensation claims and enforcement actions. Instead, *Kokesh* advanced its pro-government approach by opining that government disgorgement actions are no different from claims for compensation.

[6] *Kokesh* cited *Guar. Trust Co. of New York v. United States*, 304 U.S. 126, 132-33 (1938) (holding that this interpretive presumption did not apply to a claim by the Soviet Union against a bank to recover bank deposit), and a Tenth Circuit decision, *United States v. Telluride Co.*, 146 F.3d 1241, 1246 (10th Cir. 1998), which relied on *E.I. Du Pont De Nemours & Co. v. Davis*, 264 U.S. 456, 462 (1924) (addressing a contract claim by the United States as a World War I "war measure" railroad operator).

ISBN 1056 3059

To this end, *Kokesh* held that disgorgement is not a "penalty" under § 2462 because "disgorgement" refers only to actions for compensation or unjust enrichment. *Id*. at 1164-65. The court also concluded that disgorgement is not a "forfeiture," narrowing that term to a "historical" meaning involving *in rem* and similar proceedings. The court cited cases involving seizures of pirate ships and illegal distilleries, but it did not give a good reason for why these examples should narrow the meaning of "forfeiture" as used in § 2462. *Ibid*.

The result of *Kokesh*'s reading was to expose potential defendants to an open-ended threat of enforcement actions for money sanctions—exactly what, *Gabelli* presumed, Congress could not have intended. *See* 133 S. Ct. at 1223. Maybe there is an argument that, for some reason, Congress intended disgorgement actions to receive special treatment, but *Kokesh* never suggested one.

The result leaves a sharp disparity in limitations periods—five years on actions for fines, penalties, and forfeitures, but no limit at all on actions for disgorgement. As just noted, there is no apparent justification for this disparity. Worse, as a practical matter the disparity is an invitation to abuse, because it permits SEC to evade the limitations period by simply shifting its monetary demands to the "disgorgement" category. Recall that in *Kokesh* itself, the court endorsed a theory expanding "disgorgement" to include all benefits that any third party received from the defendant's wrong. *Kokesh*, 834 at 1164 (citing *SEC v. Contorinis,* 743 F.3d 296, 301 (2d Cir. 2014)). This is a remarkably wide-open theory; it can justify staggering "disgorgement" sanctions in, to take two common examples, insider-trading cases and accounting frauds at public companies.[7] To the extent SEC is permitted to use "disgorgement" in this aggressive way—and as *Kokesh* shows, the extent is very great indeed—SEC can essentially bypass § 2462's effort to place time limits on penalty and forfeiture actions.

The *Kokesh* reading of § 2462 gives SEC other unfair advantages as well. As *Gabelli* explained, an important reason Congress adopts limitations statutes is to shield parties from claims that the government has "allowed to slumber," then brought only "after evidence has been lost, memories have faded, and witnesses have disappeared." 113 S. Ct. at 1221 (internal quotations and citations omitted).

These are the disadvantages of stale litigation, and they hit defendants in disgorgement actions especially hard. SEC can prevail in disgorgement cases merely by giving a "reasonable approximation" of the sanction it seeks. This is an unusually low threshold; as soon as SEC meets it, the *defendant* bears the burden to prove SEC's estimate is not reasonable. *E.g.*, *SEC v. Teo*, 746 F.3d 90, 107 (3d Cir. 2014). Because of this unusual shifting burden, the disadvantage from the passing years falls more heavily on the defendant. SEC, of course, obtains a reciprocal advantage.

Still worse is the combined effect of these unfair conditions. The defendant is weighed down by combined proof disadvantages: the passage of many years and resulting loss of evidence, combined with the unusual burden to disprove SEC's sanction estimates. Thus handicapped, the defendant also must refute SEC's open-ended "disgorgement" theories, which can justify sanctions many times the defendant's gains from the conduct at issue. The result is unfairness so extreme it cannot possibly be cast as Congress's intent for § 2462.

Conclusion

Kokesh does not justify granting SEC its extraordinary claim of perpetual authority to bring disgorgement actions unchecked by any statute of limitations. If the Supreme Court applies the framework it set out in *Gabelli*, it will reverse *Kokesh* and hold that § 2462 covers SEC disgorgement actions.

[7] For example, *Kokesh* cited *SEC v. Contorinis*, 743 F.3d 296, 300 (2d Cir. 2014), in which the defendant's benefit from the wrong was $400,000 but the disgorgement order was 18 times that amount—$7.2 million—which was the profit to his company from his violations.

  ISBN 1056 3059