

# Supreme Court Applies Five-Year Statute of Limitations to SEC Disgorgement Claims

June 6, 2017

On June 5, 2017, the Supreme Court unanimously held that the five-year statute of limitations in 28 U.S.C. § 2462 applies to claims for disgorgement by the Securities and Exchange Commission (“SEC”). The Court’s opinion in *Kokesh v. SEC*<sup>1</sup> expands upon its 2013 decision in *Gabelli v. SEC*<sup>2</sup> to prohibit the SEC from seeking to recover monetary relief for conduct that occurred outside the five-year statute. This opinion may have the greatest impact on enforcement areas that tend to be resource-intensive or difficult to investigate, such as claims under the Foreign Corrupt Practices Act, but may also incentivize the SEC to speed the pace of its investigations and its use of tolling agreements.

Cleary Gottlieb argued and won the *Gabelli* case and submitted an amicus brief on the prevailing side in the *Kokesh* case.

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<sup>1</sup> 581 U.S. \_\_ (2017).

<sup>2</sup> 568 U.S. \_\_, 133 S.Ct. 1216 (2013).



## **Background**

Historically, disgorgement was an equitable power that courts used to compensate victims by awarding them defendants' wrongful gains.<sup>3</sup> Starting in the 1970s—when it lacked statutory authorization for monetary penalties—the SEC began to seek disgorgement of defendants' profits from their unlawful conduct.<sup>4</sup> Although Congress had not explicitly granted the SEC the power to seek disgorgement, the SEC and courts justified its use based on courts' inherent “equity powers.”<sup>5</sup> Over the years, disgorgement has become a powerful tool for the SEC. In 2016 alone, defendants in SEC enforcement actions were ordered to disgorge more than \$4 billion.<sup>6</sup>

In *Kokesh*, the petitioner was a long-time investment advisor when the SEC commenced an enforcement action in late 2009, accusing him of misappropriating almost \$35 million while advising funds between 1995 and 2009.<sup>7</sup> Following a finding of liability at trial in 2014, the SEC sought disgorgement of the full \$35 million, even though nearly \$30 million resulted from conduct that occurred more than five years before the SEC brought suit.<sup>8</sup> *Kokesh* argued that the SEC should not be able to seek disgorgement of the \$30 million, since 28 U.S.C. § 2462 imposes a five-year statute of limitations for “any action, suit, or proceeding for the enforcement of any civil fine, penalty or forfeiture.”<sup>9</sup>

Both the District Court for the District of New Mexico and the Tenth Circuit Court of Appeals disagreed, finding that disgorgement was not a “penalty or forfeiture” under the meaning of § 2462 because it has a remedial purpose, not a penal one.<sup>10</sup> The Court of

Appeals explained that the purpose of disgorgement “is to eliminate profit from wrongdoing while avoiding . . . the imposition of a penalty,” and that Congress did not envision that non-penal remedies such as disgorgement would be included within the purview of § 2462.<sup>11</sup>

The Tenth Circuit reached this decision against the backdrop of *Gabelli v. SEC*, a 2013 case in which the Supreme Court held that the § 2462 statute of limitations ran from the date that the defendant's conduct occurred, rather than the date that the SEC “discovered” the underlying conduct.<sup>12</sup> *Gabelli* expressly declined to address the question of whether an action for disgorgement was subject to § 2462.<sup>13</sup> Subsequently, federal appellate courts split on that question. The Tenth Circuit's decision in *Kokesh* followed earlier decisions by the D.C. and First Circuit Courts of Appeals, but it was inconsistent with a 2016 decision by the Eleventh Circuit Court of Appeals, which found that disgorgement fell within the plain meaning of “forfeiture” and was, thus, subject to the five-year statute of limitations.<sup>14</sup>

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

The Supreme Court granted certiorari in *Kokesh* to resolve this split and determine whether the SEC is permitted to seek disgorgement beyond the five-year statute of limitations, specifically addressing the question left unresolved by *Gabelli*.

Writing for a unanimous Court, Justice Sotomayor identified two factors for determining whether a specific sanction constitutes a penalty: first, whether it redresses harm to individuals or the public at large, and second, whether it deters conduct or compensates

<sup>3</sup> Restatement (3d) of Restitution & Unjust Enrichment, § 51, cmt. a (2013).

<sup>4</sup> See, e.g., *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90 (2d Cir. 1978).

<sup>5</sup> See, e.g., *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997).

<sup>6</sup> SEC, *Fiscal Year 2016 Annual Performance Report* at 39, available at

<https://www.sec.gov/files/secfy18congbudgjust.pdf>.

<sup>7</sup> Slip Op. at 3–4.

<sup>8</sup> *Id.* at 4.

<sup>9</sup> *Id.*

<sup>10</sup> *SEC v. Kokesh*, 834 F.3d 1158, 1164 (10th Cir. 2016); *SEC v. Kokesh*, No. 09-CV-1021 SMV/LAM, 2015 WL 11142470, at \*9 (D.N.M. Mar. 30, 2015).

<sup>11</sup> *Kokesh*, 834 F.3d at 1164–66 (quoting Restatement (3d) of Restitution & Unjust Enrichment, § 51(4) (2010)).

<sup>12</sup> 133 S.Ct. 1216.

<sup>13</sup> *Id.* at 1220 n.1.

<sup>14</sup> See *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016); *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008); *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010).

victims for their loss.<sup>15</sup> In considering the first factor, the Court noted that SEC actions are brought on behalf of the government—not private individuals—and that the SEC itself had conceded that it “acts in the public interest, to remedy harm to the public at large.”<sup>16</sup> As to the second factor, the Court explained that the “primary purpose” of disgorgement is “to deter violations of the securities laws,” and in many cases, disgorged funds go to the U.S. Treasury, not to victims.<sup>17</sup> The Court found that “SEC disgorgement thus 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 to compensate.”<sup>18</sup>

Although the SEC had characterized its disgorgement remedy as “remedial” and merely “restoring the status quo,” the Court rejected these arguments.<sup>19</sup> The Court observed that in many instances, defendants are forced to disgorge more than their net benefit from the wrongdoing.<sup>20</sup> For instance, in insider-trading schemes, tippers who provided confidential information to traders have been forced to “disgorge” those traders’ profits—despite never receiving any of those profits themselves.<sup>21</sup> Similarly, other defendants were forced to disgorge funds with no consideration of the costs incurred, thereby “leav[ing] the defendant worse off” than the status quo.<sup>22</sup>

Thus, the Court concluded that “[d]isgorgement, as it is applied in SEC enforcement proceedings, operates as a penalty under § 2462,” so “any claim for disgorgement in an SEC enforcement action must be commenced within five years of the date the claim accrued.”<sup>23</sup>

Notably, the Court expressly declined to address the question of “whether courts possess authority to order

disgorgement in SEC enforcement proceedings or . . . whether courts have properly applied disgorgement principles in this context.”<sup>24</sup> However, during oral arguments, several justices—including Justice Gorsuch, days after he was confirmed as the newest member of the Court—asked skeptical questions about these points, suggesting the Court may have some appetite to further address the applicability and scope of the SEC’s disgorgement power in a future case.<sup>25</sup>

### **Conclusion**

Disgorgement is one of the most powerful tools in the SEC’s enforcement arsenal, and when considering which remedies to pursue, SEC staff have relied heavily upon an assumption that claims for disgorgement “are not subject to the five-year statute of limitations under Section 2462.”<sup>26</sup>

This decision does away with that assumption, and it places a major limitation on the SEC’s claims for disgorgement. Apart from dramatically reducing the amount that can be disgorged in certain cases, the Supreme Court’s opinion in *Kokesh* hurts the SEC’s position in settlement negotiations prior to enforcement actions, as it will be more difficult to leverage the prospect of enormous disgorgements based on historical conduct. Limitations on disgorgement may become even more significant if, as seems possible, the Jay Clayton-led SEC seeks to limit the use of corporate penalties to cases where SEC staff can demonstrate that current shareholders benefited in some way from prior corporate misconduct.

To be sure, the SEC will continue aggressively to seek disgorgement from entity and individual defendants where it can do so within the limitations period. In addition, the SEC will seek to obtain tolling

<sup>15</sup> Slip op. at 5–6.

<sup>16</sup> *Id.* at 7–8.

<sup>17</sup> *Id.* at 8–9.

<sup>18</sup> *Id.* at 9.

<sup>19</sup> *Id.* at 9–10.

<sup>20</sup> *Id.* at 10.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 11.

<sup>24</sup> *Id.* at 5 n. 3.

<sup>25</sup> See, e.g., Transcript of Oral Argument at 52, *Kokesh v. SEC*, 581 U.S. \_\_ (2017) (No. 16-529) (statement by Gorsuch, J., that “there’s no statute governing it. We’re just making it up”), 7–8 (Kennedy, J., asks: “Is there specific statutory authority that makes it clear that the district court can entertain [the disgorgement] remedy?”).

<sup>26</sup> SEC Division of Enforcement, *Enforcement Manual* at 32 (Oct. 28, 2016), available at <https://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

agreements delaying the running of the statute of limitations. However, given the Court's skeptical questions at oral argument even in the face of an investment advisor who was found by a jury to have bilked his investors for many years, this case may not be the last word from the Supreme Court on the limitations of the SEC's disgorgement powers. Moreover, it can be expected that the Court's decision with respect to what constitutes a "penalty" will limit the power of other regulators who—until now—have sought to obtain disgorgement under broad principles of equitable relief.

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