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SUPREME COURT IMPOSES A FIVE-YEAR STATUTE OF LIMITATIONS ON SEC DISGORGEMENT CLAIMS

Rejecting the SEC's position, the Supreme Court unanimously holds that disgorgement sought by the Commission is a penalty subject to the federal five-year statute of limitations. The author discusses the background to the case and points to some open issues. He then considers the decision's effect on tolling agreements, the speed of filing, scope of disgorgement, tax treatment, and indemnification/insurance claims.

By Richard Marshall *

On June 5, 2017, in a unanimous decision without concurring opinions in which Justice Gorsuch participated, the Supreme Court held that a five-year statute of limitations applies to claims by the SEC for disgorgement. This important decision is the latest in a series of defeats for the SEC on the applicability of the statute of limitations to its enforcement actions. The process began almost 21 years ago and now appears finally to have resolved all of the SEC's efforts to avoid the application of statutes of limitations to its actions.

BACKGROUND

The first significant development in the application of statute of limitations to SEC actions occurred on June 21, 1996, when the D.C. Circuit unanimously held (with a panel including Justice Ginsburg) that a five-year statute of limitations applies to SEC actions seeking suspensions or censures.[1] In the *Patricia Johnson* case, the SEC sought to sanction a branch manager for failure to supervise a registered representative in her branch. The SEC filed the action more than five years after the conduct at issue had ceased. Johnson argued that the action was barred by the following statute of limitations:

> Except as otherwise provided by an 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.[2]

[1] *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996).

[2] 28 U.S.C. § 2462.

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In determining whether this statute of limitations applied to the SEC action, the court noted that "a penalty is 'the suffering in person, rights, or property which is annexed by law or judicial decision to the commission of a crime or public offense.' . . . [A] 'penalty,' as the term is used in §2462, is a form of punishment imposed by the government for unlawful or proscribed conduct, which goes beyond remedying the damage caused to the harmed parties by the defendant's action."

Applying this test, the court found that the suspension of Johnson was a penalty: "Here, the sanctions imposed by the SEC — censure and a six-month suspension — clearly resemble punishment in the ordinary sense of the word. The SEC not only restricted Johnson's ability to earn a living as a supervisor during her six-month suspension, but the suspension was also likely to have longer-lasting repercussions on her ability to pursue her vocation."[3] The court then rejected two arguments advanced by the SEC to justify its argument that a suspension was not a penalty. First, the court rejected the SEC's claim that a suspension was intended not to punish Johnson, but rather to protect the public from an incompetent supervisor: "In interpreting § 2462, . . . the court's concern is not whether Congress legislated the sanction as part of a regulatory scheme to protect the public, but rather whether the sanction is itself a form of punishment of the individual for unlawful or proscribed conduct, going beyond compensation of the wronged party." Second, the court rejected the SEC's argument that public policy considerations argued against application of the statute of limitations to its enforcement actions: "In a country where not even treason can be prosecuted, after a lapse of three years, it would scarcely be supposed, that an individual would remain forever liable to a pecuniary forfeiture."

Since all SEC enforcement actions can be appealed to the D.C. Circuit, the *Patricia Johnson* decision would seem to have resolved the issue of the application of statute of limitations to SEC enforcement actions.

The Discovery Rule and Fraudulent Concealment

In spite of the clear holding in the *Patricia Johnson* case, the decision had little, if any, practical implications for SEC enforcement actions for many years thereafter. Two doctrines were invoked by the SEC in an effort to render the *Patricia Johnson* decision irrelevant.

First, the SEC argued that, for purposes of Section 2462, the statute of limitations would not begin to run until the alleged misconduct could have been discovered by the Commission. Under this so-called "discovery rule," the statute of limitations for a particular claim would not accrue until that claim was discovered, or could have been discovered, with reasonable diligence by the plaintiff. Thus, the SEC argued that, for claims that sound in fraud, a discovery rule should be read into the relevant statute of limitations. This interpretation of the statute of limitations essentially gave the SEC five years from when it could have discovered the fraud to investigate it and file its action.

In *Gabelli v. SEC*,[4] however, the Supreme Court, unanimously and without concurring opinions, rejected this approach. The Court held that "a claim based on fraud accrues — and the five-year clock begins to tick — when a defendant's allegedly fraudulent conduct occurs." The Court reasoned that: "[t]his reading sets a fixed date when exposure to the specified Government enforcement efforts ends, advancing 'the basic policies of all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities.'. . . Statutes of limitations are intended to 'promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared.'"[5]

The Court specifically declined to apply the discovery rule to SEC actions because, unlike private litigants who can invoke the discovery rule, the SEC has many tools to detect and ferret our fraud, and has a statutory mission to do so: "Charged with this mission and armed with these

[3] *Johnson v. SEC*, 87 F.3d at 488-89.

[4] *Gabelli v. SEC*, 568 U.S. 442 (2013).

[5] *Id*. at 448.

weapons, the SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect." Moreover, "[d]etermining when the Government, as opposed to an individual, knew or reasonably should have known of a fraud presents particular challenges for the courts."[6]

The *Gabelli* decision did not address whether the statute of limitations can be tolled where the defendant affirmatively conceals its conduct from the SEC, such as by creating false documents, preparing false filings, and inducing others to lie to conceal a fraud. The *Gabelli* Court, in footnote two, noted that "[t]he court [below] distinguished the discovery rule, [which the Supreme Court rejected in *Gabelli*] which governs when a claim accrues, from doctrines that toll the running of an applicable limitations period when the defendant takes steps beyond the challenged conduct itself to conceal that conduct from the plaintiff. . . . The SEC abandoned any reliance on such doctrines below, and they are not before us." This possible exception to the holding in *Gabelli* is discussed in greater detail below.

The Court in *Gabelli* also expressly did not address whether the five-year statute of limitations applied to claims for injunctions or disgorgement: "The SEC also sought injunctive relief and disgorgement, claims the District Court found timely on the ground that they were not subject to § 2462. Those issues are not before us."[7]

Disgorgement and the Statute of Limitations

After *Gabelli*, it appeared that the *Patricia Johnson* decision would finally have a significant impact on SEC actions. In spite of this, the SEC continued to look for ways to avoid the statute of limitations by arguing that there was no statute of limitations applicable to its claims for disgorgement.

Disgorgement has been recognized as a remedy available in SEC enforcement actions for at least 50 years. In SEC administrative proceedings, disgorgement is recognized by statute.[8] In civil injunctive actions in federal court, disgorgement is not recognized by statute but has been found by many appellate courts to be an equitable remedy within the court's power to impose. In perhaps the most comprehensive analysis of a federal court's power to impose disgorgement,[9] the Second Circuit observed that, since disgorgement is an equitable remedy, "[b]ecause chancery courts possessed the power to order equitable disgorgement in the eighteenth century, we hold that contemporary federal courts are vested with the same authority by the Constitution and the Judiciary Act." In so holding, the court explained why disgorgement should be viewed as an equitable remedy.[10]

Following *Gabelli*, the SEC's claim that no statute of limitations applied to its claims for disgorgement created a significant exception to the application of the statute of limitations. This was particularly so because of significant interpretations by the Courts of Appeals that permitted expansive and apparently punitive interpretations of the disgorgement remedy. Prejudgment interest at the punitive IRS penalty rate was found to be consistent with disgorgement, even when such interest payments exceeded the amounts disgorged.[11] It was also found that profits could be

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[6] *Id.* at 451-52.

[7] *Id.* at note 1.

[8] Securities Act of 1933, Section 8A (e): "In any cease-and-desist proceeding under subsection (a), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection." *See also* Securities Exchange Act of 1934, Section 21C (e); Investment

footnote continued from previous column…

Company Act of 1940, Section 9(e); and Investment Advisers Act of 1940, Section 203 (j).

[9] *SEC v. Cavanugh*, 445 F.3d 117 (2d Cir. 2006).

[10] *Id*. at 117: "In a securities-enforcement action, as in other contexts, 'disgorgement' is not available primarily to compensate victims. Instead, disgorgement has been used by the SEC and courts to prevent wrongdoers from unjustly enriching themselves through violations, which has the effect of deterring subsequent fraud. A district court order of disgorgement forces a defendant to account for all profits reaped through his securities law violations and to transfer all such money to the court, even if it exceeds actual damages to victims. . . . In the words of Judge Friendly, '[T]he primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched.' . . . The emphasis on public protection, as opposed to simple compensatory relief, illustrates the equitable nature of the remedy. . . . Upon awarding disgorgement, a district court may exercise its discretion to direct the money toward victim compensation or to the United States Treasury."

[11] *SEC v. Teo*, 746 F.3d 90, 109 (3d Cir. 2014) ("It is within the District Court's equitable discretion to decide whether payment of interest should be ordered, and to decide upon both the interest rate and the period of time on which the interest will be calculated.").

ordered to be disgorged even when such profits did not result from the defendant's alleged wrongdoing.[12] It was not even necessary for the defendant, a person who trades on inside information for a client account for example, to have received the profits that must be disgorged — a wrongdoer can be ordered to disgorge the profits received by a related entity.[13]

THE *KOKESH* CASE

In *Kokesh v. SEC*,[14] the Supreme Court imposed the five-year statute of limitations in Section 2462 to claims for disgorgement because the Court found that this remedy was a penalty. Three reasons were presented for this holding:

> First, SEC disgorgement is imposed by the courts as a consequence for violating what we described in *Meeker* as public laws. The violation for which the remedy is sought is committed against the United States rather than an aggrieved individual — this is why, for example, a securities-enforcement action may proceed even if victims do not support or are not parties to the prosecution.
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> Second, SEC disgorgement is imposed for punitive purposes. In *Texas Gulf* — one of the first cases requiring disgorgement in SEC proceedings — the court emphasized the need "to deprive the defendants of their profits in order to . . . protect the investing public by providing an effective deterrent to future violations."
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> Finally, in many cases, SEC disgorgement is not compensatory. As courts and the Government have employed the remedy, disgorged profits are paid to the district court, and it is "within the court's discretion to determine how and to whom the money will be distributed." . . . Courts have required disgorgement "regardless of whether the disgorged funds will be paid to such investors as restitution."[15]

The Court also rejected arguments offered to support the position that disgorgement is not a penalty. First, the Court rejected the argument that disgorgement is purely remedial because "it is not clear that disgorgement, as courts have applied it in the SEC enforcement context, simply returns the defendant to the place he would have occupied had he not broken the law. SEC disgorgement sometimes exceeds the profits gained as a result of the violation." The Court also rejected the argument that disgorgement is not a penalty because it is sometimes used to compensate the victims of a fraud. "Because disgorgement orders 'go beyond compensation, are intended to punish, and label defendants wrongdoers' as a consequence of violating public laws, . . . they represent a penalty and thus fall within the five-year statute of limitations of §2462."

Finally, in footnote three of its opinion, the Court somewhat ominously noted that "[n]othing 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."

[12] *Id*. at 107 ("In light of all of this (the statute, the jurisprudence, the Restatement, and the policies grounding disgorgement remedies in SEC enforcement suits), we are not persuaded by Appellants' argument that the SEC must do more than prove but-for causation to assert a reasonable approximation of illegal profits. Moreover, as to the role of proximate causation in the court's deliberation on SEC motions for disgorgement, we conclude that when evidence of an intervening cause is raised by the Defendant it is not dispositive. The policies underlying the disgorgement remedy — deterrence and preventing unjust enrichment — must always weigh heavily in the court's consideration of whether particular profits are legally attributable to the wrongdoing, constituting unjust enrichment. It is within this context that the equitable power of the court to order disgorgement is properly exercised.").

[13] *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014)("an insider trader may be ordered to disgorge not only the unlawful gains that accrue to the wrongdoer directly, but also the benefit that accrues to third parties whose gains can be attributed to the wrongdoer's conduct. We have long applied that principle in the tipper-tippee context. . . . when third parties have benefitted from illegal activity, it is possible to seek disgorgement from the violator, even if that violator never controlled the funds. The logic of this . . . is that to fail to impose disgorgement on such violators would allow them to unjustly enrich their affiliates.").

[14] 581 U.S. ___, 137 S.Ct. 1635 (2017).

[15] 137 S.Ct. at 1643-44.

IMPLICATIONS OF *KOKESH*

Given the SEC's lack of success in avoiding application of the statute of limitations to its enforcement actions, it would seem reckless for the SEC to pursue further efforts at avoidance. Nonetheless, there are some options that might be pursued, and might be successful.

Fraudulent Concealment

As previously noted, footnote two in the *Gabelli* decision seems to reserve the possibility that the SEC can argue that a defendant's fraudulent concealment of conduct can toll the statute of limitations.

In *SEC v. Wyly*,[16] a case decided before *Gabelli*, Judge Shira A. Scheinlin, in a lengthy opinion, denied defendants' motions to dismiss the SEC's complaint on statute of limitations grounds, among others. She upheld the SEC's position that both the discovery rule and defendants' fraudulent concealment precluded dismissal.

Judge Scheindlin's opinion describes the elements of fraudulent concealment as follows: "To invoke fraudulent concealment, a plaintiff must allege that: (1) defendant concealed the cause of action; (2) plaintiff did not discover the cause of action until some point within five years of commencing the action; and (3) plaintiff's continuing ignorance was not attributable to lack of diligence on its part. . . . To establish the first element, a plaintiff must allege that: (1) defendant took affirmative steps to prevent or frustrate discovery of the alleged violation by depriving plaintiff of the information it needed to pursue its claims in a timely fashion or (2) the alleged wrong was self-concealing. '[T]he case law regarding the third prong [of fraudulent concealment] is not entirely consistent.' It has been characterized (1) as requiring a showing that the plaintiff's ignorance of the claim 'was not the result of lack of diligence' and also (2) as a requirement that a plaintiff show 'due diligence in pursuing discovery of the claim.' With respect to the first formulation, some courts have found allegations that due diligence would not have uncovered the violations sufficient. Under the second formulation, however, '[g]eneral assertions of ignorance and due diligence without more specific explanation . . . will not satisfy the[] pleading requirements;' due diligence is not adequately pled if plaintiffs 'did not allege in the [complaint] that they exercised due diligence' or if they 'make no allegation of any specific inquiries of [defendants], [or] detail when such inquiries were made, to whom, regarding what, and with what response.'"[17]

In practice, since the *Gabelli* decision, the SEC has not relied upon fraudulent concealment as a way to avoid the statute of limitations. This may be because fraudulent concealment is difficult to prove and the *Gabelli* decision leaves uncertainty about whether fraudulent concealment will be accepted by the Supreme Court.

Restitution

It could be argued that a narrower form of disgorgement would avoid the holding in *Kokesh*. Such a narrower form, perhaps labeled as restitution, would limit recovery to amounts the defendant actually received because of its misconduct and would return these funds to the victims of the defendant's misconduct. This narrower form of disgorgement addresses some of issues raised in the *Kokesh* decision, but does not address the primary argument in *Kokesh* that a remedy is a penalty when it "is imposed by the courts as a consequence for violating what we described in *Meeker* as public laws." There is also no authority supporting the view that a narrower form of disgorgement, such as restitution, would not be considered a penalty.

Suspensions Intended to Protect the Public from Incompetents

The *Patricia Johnson* decision seems to leave open the possibility that a suspension would not be a penalty if it were imposed not to punish a wrongdoer for past misdeeds but rather to protect the public from future incompetence. For example, suspending a pilot's license because he arrived late for a flight would punish him for a past act and would be a penalty. In contrast, suspending a pilot's license because he was no longer medically fit to fly would not be a penalty but instead would protect the public from an unfit pilot.

In practice, the SEC has not relied upon this rationale, perhaps because its enforcement program focuses on punishing wrongdoers for past misconduct and also perhaps because the SEC lacks both the authority and expertise to make forward-looking determinations of fitness.

[16] 788 F.Supp.2d 92 (S.D.N.Y. 2011).

[17] *Id*. at 104-05.

HOW WILL THE SEC'S ENFORCEMENT PROGRAM CHANGE?

Tolling Agreements

The SEC's Enforcement Manual contains the following discussion of tolling agreements:

> If the assigned staff investigating potential violations of the federal securities laws believes that any of the relevant conduct arguably may be outside the five-year limitations period before the SEC would be able to file or institute an enforcement action, the staff may ask the potential defendant or respondent to sign a "tolling agreement." Such requests are occasionally made in the course of settlement negotiations to allow time for sharing of information in furtherance of reaching a settlement. By signing a tolling agreement, the potential defendant or respondent agrees not to assert a statute of limitations defense in the enforcement action for a specified time period. A tolling agreement must be signed by staff at the Assistant Director level or above. Tolling agreements may not be entered without the approval of the Director of Enforcement.[18]

Tolling agreements are frequently requested in SEC investigations, with a standard form of such agreements typically used by the SEC staff.

Two aspects of tolling agreements are particularly noteworthy. First, the target of an SEC investigation is never required to sign a tolling agreement. Indeed, the *Kokesh* decision may have lessened the incentive for targets to agree to tolling agreements. Prior the *Kokesh*, the SEC took the position that the statute of limitations did not apply to its disgorgement claims. Because of this position, the target of an investigation would still need to negotiate with the SEC about disgorgement and other claims that the SEC alleged were not barred even if other claims might be barred by the statute of limitations. This increased the incentive for targets to cooperate with the SEC in an effort to negotiate the most favorable overall settlement. After *Kokesh*, a target's refusal to sign a tolling agreement might mean that all meaningful claims would be barred by the passage of time.

Second, if the SEC is forced to file an action before it is ready, the target may enjoy advantages in the subsequent litigation. These potential benefits must be weighed against the possibility that by refusing to sign a tolling agreement the target may sacrifice the time it needs to advocate its position most effectively before the SEC.

Race to File

If the target of an investigation refuses to sign a tolling agreement, *Patricia Johnson-Gabelli-Kokesh* leaves the SEC no option but to file its action as quickly as possible. This may change the enforcement program in several respects. First, the SEC may become less reasonable in granting extensions of compliance dates with its subpoenas. This, in turn, may push the limits of fairness and reasonableness in ways that have not heretofore been seen.[19] Second, the SEC may file actions too hastily, resulting in claims being asserted without proper evidence and analysis. Litigation of such ill-founded claims may become a more common practice. Third, the SEC may be forced to pare back "fishing expeditions," or investigations where every potential violation is thoroughly investigated and every potential target is thoroughly examined. Such a more focused enforcement program may actually improve both the efficiency and effectiveness of the enforcement program.

HOW WILL *KOKESH* AFFECT DISGORGEMENT CLAIMS?

Does Kokesh *Suggest the SEC Cannot Obtain Disgorgement?*

[18] *Available at* https://www.sec.gov/divisions/enforce/enforcement manual.pdf.

[19] *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1024, 1032-33 (D.C. Cir. 1978)("The federal courts stand guard, of course, against abuses of their subpoena-enforcement processes but constitutional mandates aside, "'(t)he gist of the protection is in the requirement, expressed in terms, that the disclosure sought shall not be unreasonable.'". . . . Power to enforce subpoenas of the Securities and Exchange Commission is cast in this traditional mold, without limitation on the court's discretion to set terms ensuring that the enforcement order does not become an engine of oppression. Stated somewhat differently, judicial authority to temper enforcement with fairness stems inexorably from congressional entrustment of subpoena enforcement to the judiciary.")(quoting *United States v. Morton Salt Co.*, 338 U.S. at 652-653, quoting *Oklahoma Press Publishing Co. v. Walling*, 327 U.S. at 208).

As previously noted, footnote three in the *Kokesh* decision suggests that the SEC may not have authority to seek disgorgement in its civil actions. This position has been vigorously advocated by several commentators, who argue that a federal district court's equitable jurisdiction does not extend to awarding disgorgement.[20] The holding in *Kokesh* that disgorgement is a penalty suggests that disgorgement is not an equitable remedy at all, which implies that the SEC has no authority to obtain the remedy in federal court.

A case decided on the same day as *Kokesh*, a criminal action involving forfeiture, also calls into question whether joint and several liability is available to the SEC in seeking disgorgement.[21] The *Honeycutt* decision addressed whether joint and several liability could be applied in a criminal forfeiture action to force a defendant to forfeit property received by a co-defendant. The Court unanimously held that "Congress expressly limited forfeiture to tainted property that the defendant obtained. . . . [T]hat limitation is incompatible with joint and several liability."[22]

While footnote three in *Kokesh* may have given the attacks on disgorgement new vitality, two factors argue against this position. First, as noted above, all of the federal securities laws expressly authorize the SEC to seek disgorgement in its administrative proceedings. It is difficult to understand why disgorgement would be expressly authorized in administrative proceedings but not be available to the SEC in civil injunctive actions. Second, courts have recognized the SEC's power to obtain disgorgement for almost 50 years.[23] Indeed, there is not a single lower-court opinion that has found that the SEC lacks the authority to obtain disgorgement.

Narrowing of Aggressive Interpretations of the Remedy

Even if the courts continue to recognize the SEC's authority to obtain disgorgement, the *Kokesh* decision will likely make it more difficult for the SEC to obtain the relief. Prior to the *Kokesh* decision, most courts found that disgorgement is an "equitable remedy"[24] designed to deprive wrongdoers of unjust enrichment. The characterization of disgorgement as a "penalty" likely will change the way courts approach this remedy.

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[20] Russell Ryan, "*The Equity Façade of SEC Disgorgement*," 4 Harvard Business Law Review Online (Nov. 2013), *available at* http://www.hblr.org/wp-content/uploads/2013/11/Ryan__The-Equity-Façade-of-SEC-Disgorgement.pdf ("The prevailing notion that SEC disgorgement is an inherently equitable remedy ought to be thoughtfully revisited. Courts award the SEC billions of dollars in disgorgement each year, yet in many cases the premise of equity seems squarely at odds with the Supreme Court's analysis of restitution in *Great-West*. Given the amounts at stake in these cases, as well as the significant procedural disadvantages a defendant confronts when a court acts in equity rather than at law, the long-standing premise of equity warrants a higher degree of skepticism and scrutiny than it has received thus far."); Francesco DeLuca, "*Sheathing Restitution's Dagger Under the Securities Acts,*" 2013-2014 Review of Banking and Financial Law 899, *available at* https://www.bu.edu/rbfl/files/2014/03/RBFL-Vol-33.2_DeLuca.pdf ("Under Supreme Court precedent, a remedy falls within a federal court's equity jurisdiction if, but only if, the English High Court of Chancery ordered a functionally equivalent remedy in 1789. However, the Chancery did not award money judgments measured by the amount of a wrongdoer's profit attributable to his wrong except in cases involving an abuse of a fiduciary relationship. Because the SEC's disgorgement remedy does not require a fiduciary relationship, the remedy has no analog in 1789 Chancery decisions. Accordingly, federal courts may not award the SEC's disgorgement remedy pursuant to their equity jurisdictions.").

[21] *Honeycutt v. United States*, 581 U.S. ___, 137 S. Ct. 1626 (2017).

[22] *Id.* at n. 2.

[23] The SEC first sought and obtained disgorgement in *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 92–94 (S.D.N.Y. 1970); *aff'd in part and rev'd in part*, 446 F.2d 1301, 1307–08 (2d Cir. 1971), and has done so innumerable times since. *See generally* John D. Ellsworth, Disgorgement in Securities Fraud Actions Brought by the SEC, 1977 Duke L.J. 641, 641–42 n.3 (1977); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1054 (5th ed. 2004); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188, 1188 (1975); *see*, e.g., *SEC v. Lipson*, 278 F.3d 656, 662–63 (7th Cir. 2002); *SEC v. Manor Nursin g Ctrs., Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1972); *SEC v. Chester Holdings, Ltd.*, 41 F. Supp. 2d 505, 528 (D.N.J. 1999); *SEC v. R. J. Allen & Assocs., Inc.*, 386 F. Supp. 866, 880 (S.D. Fla. 1974).

[24] *See, e.g., SEC v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991) ("The disgorgement remedy [the district court judge] approved in this case is, by its very nature, an equitable remedy . . . ." (emphasis added)); *First City Fin*, 890 F.2d at 1230 ("Disgorgement is an equitable remedy . . . ."); *SEC v. Certain Unknown Purchasers of Common Stock of and Call Options for Common Stock of Santa Fe Int'l Corp.*, 817 F.2d 1018, 1020 (2d Cir. 1987) ("The disgorgement remedy approved by the district court in this case is, by its nature, an equitable remedy." (emphasis added)).

It can be expected that courts will be more reluctant to grant the remedy, and more reluctant to accept novel and aggressive applications of the remedy.

Impact on Tax Treatment

Section 162(a) of the Internal Revenue Code permits deductions of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[25] Payments made pursuant to court judgments or settlements in a business context generally satisfy the "ordinary and necessary" requirement of Section 162(a) and may be deducted by the taxpayer. Section 162(f), however, imposes a limitation on deductions under Section 162(a), stating that "no deduction shall be allowed . . . for any fine or similar penalty paid to the government for the violation of any law." This limitation applies to actual fines and penalties, as well as to amounts "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)."[26] The IRS Chief Counsel has recently opined, but before *Kokesh*, that disgorgement in the securities context is sometimes compensatory and sometimes penal.[27] Specifically, where the amount of the disgorgement equals the damages incurred by the victims of the illegal activity and the SEC uses the disgorgement to compensate those investors, the IRS recognized that SEC disgorgement might be compensatory. On the other hand, where the disgorgement is intended to deprive the wrongdoer of illegal profits or deter future illegal conduct, it is more likely to be penal for tax purposes.

Last year, in *Nacchio v. United States*,[28] the Court of Appeals for the Federal Circuit held that a payment required under a criminal forfeiture statute for violations of the securities laws was a fine or penalty within the meaning of Section 162(f). In reaching this holding, the Federal Circuit cited two factors that the Supreme Court cited in *Kokesh*. The Federal Circuit noted that although the government may direct forfeiture payments to the victims of a crime, this does not make forfeiture a form of compensation. Whereas compensation is measured by the damages incurred by the victims, forfeiture is measured by the illicit gains to the perpetrator. Forfeitures may thus exceed or fall short of the amount necessary to compensate victims. The Federal Circuit also noted that even where the government subsequently distributes a forfeiture payment to victims of the criminal activity, the forfeiture is first and foremost a remedy for public harms, not private harms.

The *Kokesh* decision makes it likely that disgorgement payments will no longer be deductible from the target's taxes as an expense.

Impact on Indemnification and Insurance Claims

Kokesh calls into question whether disgorgement will continue to be indemnified either under corporate indemnification obligations or by insurance policies. Prior to *Kokesh*, SEC settlements generally did not preclude indemnification for disgorgement, thereby allowing defendants to obtain indemnification for the disgorgement portion of any settlement, to the extent the disgorgement amount was otherwise subject to indemnification. Since *Kokesh* holds that disgorgement is a penalty, it will likely be subject to the provisions of insurance policies which preclude indemnification for penalties,[29] and such indemnification may also be

[25] 26 U.S.C.A. I.R.C. § 162(a).

[26] Treas. Reg. § 1.162-21(b)(1)(iii).

[27] I.R.S. Chief Couns. Mem. CCA 201619008 (May 6, 2016), *available at* https://www.irs.gov/pub/irs-wd/201619008.pdf.

[28] 824 F.3d 1370, (Fed. Cir. 2016), cert. denied, 582 U.S. ___ (2017).

[29] Some courts have held that disgorgement, because it can be viewed as involving the return of improperly acquired funds, does not constitute "loss" or "damages" within the meaning of insurance policies. *Level 3 Communications Inc. v. Federal Ins. Co.*, 272 F.3d 908, 910 (7th Cir. 2001); *Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 10 A.D.3d 528, 528 (1st Dept. 2004). Some courts have also held that public policy prohibits an insured from receiving indemnification for the disgorgement of its own illicit gains. *Bank of the West v. Superior Ct.*, 833 P.2d 545, 555 (Cal. 1992).

Some courts have ordered indemnification for disgorgement. For example, in *J.P. Morgan Securities Inc. v. Vigilant Ins. Co.*, 21 N.Y.3d. 324 (2013), Bear Stearns was ordered to disgorge $160 million to the SEC. After paying the judgment, Bear Stearns sought indemnification from its insurers. Because the parties' contract did not explicitly preclude reimbursement for disgorgement and the $160 million disgorged to the SEC arose from profits of its customers (rather than from Bear Sterns itself), the New York Court of Appeals ordered the insurers to fully reimburse Bear Stearns for the disgorgement amount. However, after the *Kokesh* decision, the insurers sought review of the Court of Appeals decision based upon the Supreme Court's determination that disgorgement is a penalty. Other states (including Delaware) favor the insurability of disgorgement claims. *U.S. Bank Nat'l Ass'n v. Indian Harbor Ins. Co.*, No. 12-cv-3175, 2014 BL 186122, at *3 (D. Minn. July 3, 2014) (applying Delaware law and holding that "no Delaware authority has held that restitution is uninsurable as a matter of law").

against public policy.[30] It also is unclear whether the holding in *Kokesh* that disgorgement amounts to a penalty will lead the SEC to alter its settlements to preclude indemnification for disgorgement.

CONCLUSION

Perhaps the clearest lesson from the SEC's defeat in *Kokesh* is that the SEC should listen to guidance from appellate judges. One Judge, Justice Ginsburg, participated in *Patricia Johnson, Gabelli,* and *Kokesh.* Justice Ginsburg is hardly viewed as a pro-business and anti-enforcement Judge. Yet, time after time, the SEC sought to avoid her rulings on the application of the statute of limitations to its enforcement actions. It is now time for the SEC to give up the fight and comply with the guidance of the Court. ■

[30] Many courts have held that indemnification of penalties is contrary to public policy. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969); *Eichenholtz v. Brennan*, 52 F.3d 478 (3d Cir. 1995); *Heizer Corp v. Ross*, 601 F.2d 330 (7th Cir. 1979); *First Golden Bancorporation v. Weiszmann*, 942 F.2d 726 (10th Cir. 1991); *City of Fort Pierre v. United Fire & Cas. Co.*, 463 N.W.2d 845 (S.D. 1990).