

SCOTUS Limits SEC Disgorgement: What It Means for Sam Wyly and Other Defendants

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(June 12) – On June 5, the Supreme Court of the United States **imposed a five-year statute of limitations** on any claim for disgorgement in a Securities and Exchange Commission enforcement action. The ruling will have a substantial impact on ongoing enforcement actions by the SEC, including *SEC v. Wyly* in the Second Circuit.

A unanimous court—including newly minted Justice Neil Gorsuch—overturned a Tenth Circuit decision that drew a distinction between disgorgement and other monetary civil penalties for the purposes of 28 U.S.C. § 2462.

Justice Sonia Sotomayor, writing for the Court, wrote that the five-year statute of limitations established by § 2462 was applicable to SEC disgorgement orders, such as monetary civil penalties, because disgorgement operates as a penalty under that section.

This limitations period imposed by the Court means that defendants facing SEC enforcement actions now have an important protection from disgorgement of funds over an unlimited time period. Indeed, the Court even hinted that the concept of disgorgement itself might be eliminated in the near future.

Background

Before the 1970s, the Commission's authority in enforcement proceedings was limited to injunctions barring future action. Courts began ordering disgorgement along with injunctions in the 1970s to deprive wrongdoers of their ill-gotten gains. In 1990, Congress passed legislation allowing the SEC to seek civil monetary damages. In 2013, the Supreme Court held that 28 USC § 2462, which imposed a five-year limitations period on any enforcement action for a "civil fine, penalty, or forfeiture," applies when the Commission seeks monetary civil penalties.

In recent years, circuit courts split on whether the statute of limitations also applied to disgorgement orders. The First, Tenth, and D.C. Circuits opined that the statute did not apply because disgorgements were not a penalty. But the Eleventh Circuit found that the statute applied because disgorgement was essentially the same as forfeiture. In January 2017, the Supreme Court granted review in *Kokesh v. SEC* to resolve this circuit split. – a

History of *Kokesh v. SEC*

In 2009, the Commission instituted an enforcement action against Charles Kokesh, alleging that he violated various securities laws and received ill-gotten gains totaling \$34.9 million from 1995 to 2009. The SEC sought monetary civil penalties and disgorgement along with an injunction barring Kokesh from any future violations of securities laws.

After a jury found that Kokesh violated the securities laws, the district court applied § 2462's five-year statute of limitations to the monetary civil penalties, but determined that no such limitations period applied to the \$34.9 million disgorgement judgment (\$29.9 million of which accrued outside the limitations period imposed on the civil penalties). The Tenth Circuit affirmed, holding that the statute of limitations did not apply because a disgorgement order was neither a "penalty" nor a "forfeiture" within the meaning of § 2462.

Supreme Court's Reasoning in *Kokesh* Decision

The Supreme Court held that disgorgement in the context of SEC enforcement actions constituted a penalty under § 2462 and was subject to a five-year statute of limitations beginning on the date the claim accrued. The Court noted that disgorgement often functions as a penalty because it is imposed as a consequence for violating public laws with the primary purpose of deterring future violations. "Sanctions imposed for the purpose of deterring infractions of public laws are inherently punitive," wrote Justice Sotomayor.

Further, in many cases, SEC disgorgement is not compensatory, as some funds are paid to the victims and other funds are dispersed to the Treasury. A payment made to the government as a consequence of violating a law is non-compensatory and operates as a penalty.

The government's primary argument against categorizing disgorgement as a penalty was that SEC disgorgement is merely remedial and returns the defendant to the position he would have occupied prior to the violation. However, the Court noted that sometimes a defendant is disgorged of more than just his ill-gotten gains, which leaves the defendant worse off. For example, a defendant found guilty of insider trading could be disgorged of the entire amount of profit made by those who traded on insider information, even though the insider never actually saw this money. Thus, the Court concluded that disgorgement in the context of SEC enforcement actions is punitive rather than remedial even if it also serves some compensatory purpose.

As noted by Justice Sotomayor, a statute of limitations is "vital to the welfare of society." In order to be just, an action must be timely and fresh. As years pass from the time a claim accrues, memories fade and access to evidence becomes more difficult. Before the Court's holding in *Kokesh*, the SEC could bring actions for disgorgement in cases that were decades old.

Predicted Impact of *Kokesh* Decision

Past and Present SEC Cases

The *Kokesh* decision will have an immediate impact on both current and past SEC cases, as well as a lasting impact on SEC enforcement actions and the agency as a whole. SEC disgorgement makes up the largest chunk of monetary sanctions collected by the SEC, more than doubling the amount collected for other penalties. In 2016, the SEC collected \$2.8 billion in disgorgement orders compared to \$1.27 billion in other monetary penalties.

Although the precise number of impacted SEC cases is currently unknown, it is clear that the SEC will have to reevaluate each of its ongoing investigations and prosecutions to determine (1) what proceeds, if any, were obtained outside of the new limitations period, and (2) whether the potential recovery under the new limitations period is still worth pursuing.

Further, the SEC may lose part of the disgorgement in cases that have already been decided, as some defendants might ask courts to order repayment in light of this decision. However, defendants who received court-ordered disgorgement will likely have far more leverage to demand this repayment than those who were disgorged of gains as part of a settlement agreement.

Future Enforcement Actions

The SEC will also be disadvantaged in future enforcement actions. For example, potential violators will now have less incentive to self-report violations while hoping to wait out limitations. Targets of new enforcement actions in complicated matters might also feel less inclined to waive the limitations period by agreement, based on the assumption that the SEC will give up on protracted investigations as the available disgorgement withers.

At the very least, the SEC will now have less leverage to request these waivers. They will also have less to offer potential whistleblowers, as the funds used to reward them are derived from the SEC's monetary sanctions.

Additionally, SEC actions enforcing the Foreign Corrupt Practices Act (FCPA) will be particularly impacted, as these generally involve high dollar schemes that span multiple years and require significant time and resources to investigate.

In 2016 alone, the SEC collected over \$400 million in just two FCPA enforcement actions. Had the new limitations period been imposed, the SEC would have been barred from disgorging Teva Pharmaceutical Industries, a company with \$236 million of ill-gotten gains from 2002 through 2012, and Och-Ziff, a company with \$199 million of ill-gotten gains from 2007 through 2011.

General Validity of Disgorgement

In addition to imposing this significant limitation, the Court in *Kokesh* hinted that it may revisit the topic of SEC disgorgement orders to determine whether such orders are valid in the first place.

During oral arguments, the Justices expressed a seemingly unanimous concern that no statutory authorization exists for SEC disgorgement. Courts created the concept at a time when only injunctive relief was available in SEC enforcement proceedings. However, courts continued to order disgorgement even after Congress passed legislation authorizing the collection of civil monetary penalties in SEC enforcement actions.

Now that the high court has labeled disgorgement as a penalty, the question is raised as to whether both types of penalties—disgorgement and civil monetary penalties—are legally available in SEC enforcement actions. Notably, Justice Sotomayor mentioned in a footnote that nothing in the *Kokesh* opinion answered the questions of “whether courts possess authority to order disgorgement in SEC enforcement proceedings or ... whether courts have properly applied disgorgement principles in this context.” But the question clearly remains open.

Local Impact: *SEC v. Wyly*

The *Kokesh* ruling also garnered immediate attention in a Second Circuit case involving former Michaels Stores chair and Dallasite Sam Wyly. In 2010, the SEC charged brothers Sam and Charles Wyly with violating federal securities laws related to ownership and trading of securities in companies in which they were insiders. In 2015, the SEC won a securities fraud suit in a New York federal district court that accused the brothers of orchestrating a 13-year fraud scheme. This action resulted in a \$300 million judgment against the Wyllys, \$187 million of which was disgorgement.

Sam Wyly and the estate of Charles Wyly appealed to the Second Circuit. In January of this year, counsel for the Wyllys urged the court to address the issue of whether the statute of limitations applies to disgorgement orders. In the alternative, the Wyllys urged the court to put the case on hold until the Supreme Court ruled in *Kokesh v. SEC*. In the wake of the Supreme Court's decision in *Kokesh*, the Second Circuit just ordered both sides to submit briefs explaining how their positions are effected by the ruling.

Based on the high court's ruling, it is likely that at least a portion of the judgment remaining against the Wyllys will be vacated. Additionally, the portion of the judgment relating to Charles Wyly could be vacated in its entirety due to Charles' death in 2011. Because the Court labeled disgorgement as a penalty imposed with the purpose of deterring wrongful conduct, the penalty may not survive the death of the wrongdoer. In any event, the *Kokesh* decision is an important development in the Wyllys' Second Circuit appeal.

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