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Expert Analysis

Other People's Money: SEC Disgorgement After 'Kokesh'

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Should individuals sued by the SEC have to give up, or "disgorge," corporate gains resulting from a fraud, or just their own direct gains? In an Aug. 29 summary order, *SEC v. Metter*,[1] the U.S. Court of Appeals for the Second Circuit avoided wrestling with this question, but it may be one of the next major battles in the wake of the Supreme Court's June 5, 2017 decision in *Kokesh v. SEC*, 137 S. Ct. 1635. *Kokesh* held that the disgorgement remedy in SEC enforcement actions is a "penalty" for purposes of the five-year limitations period for the "enforcement of any civil fine, penalty, or forfeiture." 28 U.S.C. §2462. Many have assumed, on the basis of a footnote in the decision, that courts will soon be considering whether they have authority to order disgorgement at all in SEC enforcement actions. That issue certainly lurks, but I suspect that courts first will revisit the proper scope of the remedy, including whether a court may force a defendant to "disgorge" ill-gotten gains that the defendant did not personally receive but that went to third parties, such as individuals and entities associated with the defendant.

> 'Kokesh' and its footnote are likely to make courts hesitant to impose disgorgement awards that go far beyond restoring the status quo and into the realm of the undeniably punitive.

Legal Background

Kokesh arose from Charles Kokesh's use of investment-adviser firms he owned to misappropriate funds from clients. 137 S. Ct. at 1641. Kokesh himself did not pocket all the proceeds from this scheme, some of which were paid to other officers of the firms and to a landlord for office rent. *SEC v. Kokesh*, 834 F.3d 1159, 1161 (10th Cir. 2016); *SEC v. Kokesh*, 2015 WL 11142470, at *9-10 (D.N.M. March 30, 2015). Kokesh was nevertheless ordered to pay the government, as disgorgement of ill-gotten gains, the full amount of the misappropriated funds (about $35 million) plus prejudgment interest of about $18 million. Most of the money was misappropriated more than five years before the SEC filed suit. 137 S. Ct. at 1641.

Key to the legal backdrop is that there is no express statutory authority for "disgorgement" in an SEC enforcement civil action.[2] Rather, since the remedy first appeared in the early 1970s, the SEC and courts have defended it as an exercise of the court's inherent equitable powers, analogous to restitution used to prevent unjust enrichment.[3] In 2002, the

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Sarbanes-Oxley legislation amended the Securities Exchange Act of 1934 to provide that in an SEC enforcement action, "the Commission may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors,"[4] and courts have occasionally cited this provision as authority to order disgorgement.[5] The SEC has long argued that disgorgement is not subject to the five-year time bar because it is an "equitable remedy" rather than a "fine, penalty, or forfeiture."

Supreme Court Decision

The Supreme Court resolved the case without expressly addressing whether disgorgement is "equitable," or even really using the word. The court concluded, in a unanimous opinion authored by Justice Sonia Sotomayor, that disgorgement operates as a "penalty" for purposes of the statutory time bar because it is imposed "as a consequence of violating a public law," is intended for "punitive purposes," namely deterrence, and is not "compensatory" in that funds are not necessarily distributed to victims. 137 S. Ct. at 1643-44.

The court also rejected the SEC's view that disgorgement is not punitive but remedial because it "'restor[es] the status quo.'" Id. at 1644 (quoting the SEC's brief). Sotomayor noted that "SEC disgorgement sometimes *exceeds the profits gained as a result of the violation*," and that a wrongdoer, such as an inside-trader, can 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*.'" Id. at 1644 (emphasis added and quoting *SEC v. Contorinis*, 743 F.3d 296, 302 (2d Cir. 2014)[6]).

Sotomayor also observed that, "*as demonstrated by this case*, SEC disgorgement sometimes is ordered without consideration of a defendant's expenses that reduced the amount of illegal profit," "'result[ing] in a punitive sanction that the law of restitution normally attempts to avoid.'" Id. at 1644-45 (emphasis added; quoting the Restatement (Third) of Restitution). "*In such cases*," the court remarked, disgorgement does "not simply restore the status quo," but rather "leaves the defendant worse off." Id. at 1645 (emphasis added). The court thus seems to have accepted Kokesh's argument, pressed unsuccessfully below, that his "disgorgement order is punitive because he is being required to disgorge *more than he actually gained himself* (some of the misappropriated money went to others)." 834 F.3d at 1164 (emphasis added).[7]

The Footnote

If disgorgement in general (or Kokesh's order specifically) is punitive enough to be a real *penalty* (not just a "penalty"—in quotation marks—for purposes of a particular statute of limitations), then, like any civil penalty, it would require express congressional authorization. But the only relevant authorization is for "equitable relief…for the benefit of investors."[8] Legal taxonomies and labels are sometimes slippery, but *Kokesh* was litigated on the premise, shared by many litigants and courts, that "equitable relief" and punishment are mutually exclusive categories. If disgorgement is truly a punishment, it is not "equitable." And if it is not "equitable," it is not authorized.

Presumably mindful that pronouncing disgorgement a "penalty" threatened the remedy's legal moorings, the court delivered its now famous footnote: "Nothing 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*." 137 S. Ct. at 1642 n.3 (emphasis added). The italicized portion of the footnote deserves attention. I believe that in the near term, it is less likely that courts jettison disgorgement wholesale[9] than that they explore whether the remedy can be confined to something less punitive and more recognizably "equitable."

'Metter'

SEC v. Metter appeared to be an occasion for the Second Circuit to do just that. Michael Metter was the CEO of

Spongetech Delivery Systems, which (according to SEC allegations deemed true for the proceedings) was the subject of a large "pump-and-dump" scheme orchestrated in part by Metter. *SEC v. Spongetech Delivery Sys.*, 2015 WL 5793303 (S.D.N.Y. Sept. 30, 2015). Metter was ordered to disgorge $52 million because proceeds totaling that amount from the sale of Spongetech shares had flowed to the bank account, controlled by Metter, of RM Enterprises International, Inc. (RM), an entity controlled by Metter and a co-defendant. Id. at *3. Metter and the co-defendant beneficially owned two-thirds of RM (Summary Order, 2017 WL 3708084, at *1)—suggesting that Metter may have been personally interested in only a fraction of RM's proceeds. In fact, the district court, for purposes of calculating a separate civil penalty, pegged Metter's personal gross pecuniary gain from the scheme at about $6 million. 2015 WL 5793303, at *4, *11. The district court rejected Metter's argument that he should not be required to disgorge amounts he did not personally receive.

The district court relied principally on the Second Circuit's 2014 decision in *SEC v. Contorinis*, id. at *3—one of the very cases cited by Sotomayor as a demonstration of the punitive, non-"remedial" nature of disgorgement. The Contorinis defendant was a portfolio manager at a hedge fund who was ordered to disgorge $7.2 million that the fund gained from his insider trading, even though the defendant did not personally enjoy those profits. 743 F.3d at 299. The primary beneficiaries of the defendant's misconduct were presumably the investors in the hedge fund.

A Second Circuit panel upheld the award over a dissent by Judge Denny Chin, accepting the SEC's view that a violator "should be compelled to return not only those profits from the fraud that he has reserved for his own use, but also those that he has bestowed on others." Id. at 302. The majority noted that such a rule "prevents insider traders from evading liability by operating through or on behalf of third parties," and asserted that "limiting disgorgement amounts to the pecuniary benefit enjoyed by the wrongdoer would run contrary to the equitable principle that the wrongdoer should bear the risk of any uncertainty affecting the amount of the remedy." Id. at 304, 306.[10]

Chin countered that disgorgement "should have the effect of returning a defendant to his status quo prior to the wrongdoing," id. at 310—exactly what the Supreme Court said disgorgement seems not to do in cases like *Contorinis* and *Kokesh* itself. Chin observed that the Contorinis majority "penalized" the defendant, even though "disgorgement…is not intended to be punitive; it is remedial in nature." Id. at 309. Although the defendant "undeniably deserved to be punished, disgorgement was not the proper mechanism" for imposing that punishment. Id. at 310.[11]

The Second Circuit deferred deciding *Metter* until after the Supreme Court had decided both *Kokesh* and *Honeycutt v. United States*, where the question was whether a defendant may be held jointly and severally liable under a drug-crimes forfeiture statute for property that the defendant did not acquire.[12] *Kokesh* and *Honeycutt,* 137 S. Ct. 1626, came down on the same day, authored by the same justice (they also had the same petitioner's counsel), and both sided with the petitioner-defendants. Metter then argued to the Court of Appeals that the upshot of *Kokesh* is that "disgorgement remains permissible only where it does not cross the line and become punitive, but remains consistent with traditional equitable principles."[13] This argument should be—and likely will be in future cases—taken seriously.

But the Metter panel did not bite. It issued a summary order that did not discuss *Contorinis*, and contained minimal discussion of the fact that Metter was being ordered to disgorge gains he did not personally reap. The summary order explained in a footnote that *Honeycutt* was not controlling because it dealt with a drug-forfeiture statute and because Metter, unlike the Honeycutt defendant, controlled the entity that received the relevant proceeds. 2017 WL 3708084, at *2 n.2. Surprisingly, the panel also referred in passing to "the equitable remedy

of disgorgement"—without addressing whether that characterization is consistent with Kokesh, and if it is not, what the implications might be in a case in which the disgorgement order would leave the defendant "worse off" than before the fraud. Id.[14]

Conclusion

This issue is likely to arise again (provided the SEC does not alter its approach to disgorgement).[15] *Kokesh* leaves little doubt that ordering a defendant to disgorge many millions that he never possessed can be punitive. And yet the SEC commonly seeks such disgorgement awards.[16] The courts have mostly acquiesced, seeing nothing unjust about holding an acknowledged fraudster liable—individually or jointly and severally with his confederates or wholly controlled entities—for the proceeds of a fraud, particularly when shell games may make it impractical to figure out exactly where the money went, let alone to recover it. But the prevailing approach can also result in overpunishment, or unprincipled punishment. There are cases in which there is no real doubt about who benefited from a violation and in what amount, such as when misconduct redounds to the benefit of a hedge fund or mutual fund. Going forward, the Kokesh footnote is likely to play a major role in mediating among the competing policy concerns. In all events, *Kokesh* and its footnote are likely to make courts hesitant to impose disgorgement awards that go far beyond restoring the status quo and into the realm of the undeniably punitive.

1. No. 16-526, 2017 WL 3708084 (2d Cir. Aug. 29, 2017).

2. In 1990, Congress expressly authorized disgorgement in SEC administrative proceedings. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429 §§102, 202, 203, 301, 401, 104 Stat. 931, codified in relevant part at 15 U.S.C. §§77h-1(e), 78u-2(e), 78u-3(e), 80a-9(e) & (f)(5), 80b-3(j) & (k)(5) (2016). Such proceedings are beyond the scope of this discussion.

3. See *Kokesh*, 137 S. Ct. at 1641; see also Br. of SEC at 10, *Kokesh v. SEC*, No. 16-529 (U.S.).

4. Sarbanes-Oxley Act of 2002, Pub. L. 107-204 §305, 116 Stat. 745 (2002), codified at 15 U.S.C. §78u(d)(5) (2016).

5. See *SEC v. World Capital Market*, 864 F.3d 996, 1003 (9th Cir. 2017); *SEC v. Mantria*, 2012 WL 3778286, at *1 (D. Colo. Aug. 30, 2012).

6. *Contorinis* is discussed below.

7. See also 2015 WL 11142470, at *9-10 ("Defendant's argument—that any disgorgement of monies that he distributed to third parties would not be equitable—holds water only on the most superficial review….Requiring Defendant to give up his ill-gotten gains—even those he received many years ago and those he caused to be paid to third parties—is quintessentially equitable.").

8. The statutes confer power to impose civil penalties, but the SEC seeks such penalties separately from disgorgement and they are beyond the scope of this discussion. In *Kokesh*, the civil penalty award, $2.35 million, was dwarfed by the disgorgement order. 137 S. Ct. at 1641.

9. Despite occasional provocative critiques, see, e.g., Russell Ryan, "The Equity Façade of SEC Disgorgement," Harv. Bus. L. Rev. Online (2013), the availability of disgorgement as an exercise of equitable power in SEC actions was universally accepted by the courts before *Kokesh*. Congress also has repeatedly assumed the existence of disgorgement authority in SEC actions. See, e.g., 15 U.S.C. §§77t(f), 78t-1(b)(2), 78u(d)(4), 78u-6(a)(4), 7246(a) & (c) (references to funds disgorged in an SEC enforcement action in enactments from 1988, 1995, 2002, and 2010); see also S. Rep. No. 205, 107th Cong. 2d Sess., at 27 (2002) (Senate report on Sarbanes-Oxley legislation) ("For a securities law violation, currently an individual may be ordered to disgorge funds that he or she received 'as a result of the violation.' Rather than limiting disgorgement to these gains, the bill will permit courts to impose any equitable relief necessary or appropriate to protect, and mitigate harm to, investors.").

10. This principle seems to be a questionable fit for a case like *Contorinis*: there was no apparent "uncertainty" about the fact that most of the fund's gains did not go to Contorinis personally.

11. Contorinis was also ordered to pay a $1 million civil penalty, and, in a parallel criminal case before the same judge, sentenced to six years in prison and a $427,875 forfeiture. 743 F.3d at 300. The judge at one point additionally sought to fine Contorinis $2 million in the criminal action, but was satisfied that further punishment was unnecessary once the Second Circuit upheld the SEC disgorgement award. See *United States v. Contorinis*, 09-cr-1083 (S.D.N.Y.) (ECF 111, 114, 126, 132).

12. Order, *SEC v. Metter*, No. 16-526-cv (2d Cir. May 3, 2017) (ECF 121).

13. Supp. Br. for Appellant, *SEC v. Metter*, 16-526-cv (2d Cir. June 20, 2017) (ECF 125).

14. Disposing of an Eighth Amendment argument, the panel "assum[ed] without deciding" that, in light of *Kokesh*, the disgorgement liability "was essentially punitive in nature," but the panel did not attempt to reconcile that statement with the "equitable remedy" characterization. 2017 WL 3708084, at *2.

15. The Contorinis majority noted that "Circuits which have considered related issues are mixed regarding the extent to which a party can be ordered to disgorge total gain from an unlawful act, when the party has not personally received the full benefit of the wrongdoing." 743 F.3d at 305 n.5.

16. Whether the SEC meaningfully collects on them is a separate question beyond the scope of this discussion.

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