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Kokesh Footnote Three Notwithstanding: The Future of the Disgorgement Penalty in SEC Cases

Stephen M. Bainbridge*

The Securities and Exchange Commission (SEC) long has relied on disgorgement of ill-gotten gains as a principal penalty in civil securities fraud litigation, especially in insider trading cases brought under Securities Exchange Act section 10(b) and Rule 10b-5.¹ Curiously, however, it has done so despite the absence of any statutory authorization for the disgorgement penalty.² In the absence of a statutory framework, the courts have had to flesh out the substantive and procedural aspects of disgorgement via interstitial lawmaking. In *Kokesh v. SEC*,³ the U.S. Supreme Court continued that process by taking up the seemingly technical—but surprisingly important⁴—question of what statute of limitations applies to SEC disgorgement actions. In doing so, however, the Court’s opinion actually cast considerable doubt on the validity of the seemingly well-established disgorgement sanction.⁵

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1 See, e.g., *SEC v. Henke*, 275 F. Supp. 2d 1075, 1083 (N.D. Cal. 2003) (describing disgorgement as one of the SEC’s “traditional equitable remedies”).

2 See, e.g., *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989) (explaining that “disgorgement is rather routinely ordered for insider trading violations despite a similar lack of specific authorizations for that remedy under the securities law”).

3 *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

4 For a discussion of the importance of that issue, see Stephen M. Bainbridge, *Outcome of Recently Argued “Kokesh” SCOTUS Case Will Impact SEC’s Use of Potent Disgorgement Authority*, WLF LEGAL PULSE (April 25, 2017), <https://wfllegalpulse.com/2017/04/25/outcome-of-recently-argued-kokesh-scotus-case-will-impact-secs-use-of-potent-disgorgement-authority/>.

5 See, e.g., Andrew J. Morris, “*Kokesh v. SEC*”: *Its Wide-Ranging (and Mostly Good) Implications for Disgorgement Actions*, WLF LEGAL PULSE (June 14, 2017), <https://wfllegalpulse.com/2017/06/14/kokesh-v-sec-its-wide-ranging-and-mostly-good-implications-for-disgorgement-actions/> (“*Kokesh* raises . . . the threshold question of whether the SEC has the authority to obtain any disgorgement at all.”). Prior to this holding, the law was thought to be well-established. See, e.g., *SEC v. Yun*, 148 F. Supp. 2d 1287, 1290 (M.D. Fla. 2001) (“As the SEC notes, disgorgement is usually considered rather routine; if a person is found to have violated the securities laws, and profited from the ensuing transaction, courts simply order the disgorgement of those profits.”); *SEC v. Novus Techs., LLC*, No. 2:07-CV-235-TC, 2010 WL 4180550, at *40 (D. Utah Oct. 20, 2010), *aff’d sub nom*; *SEC v. Thompson*, 732 F.3d 1151 (10th Cir. 2013) (“It is well settled that the SEC may seek, and courts may order, disgorgement of ill-gotten gains in SEC injunctive actions.”).

I. THE *KOKESH* CASE

Charles Kokesh owned and controlled a pair of investment adviser firms that, in turn, managed four business development corporations (BDCs).⁶ Both the investment advisers and the BDCs were registered with the SEC. The SEC alleged that Kokesh misappropriated almost \$35 million from the BDCs for the benefit of himself and the investment adviser firms.⁷ After a civil trial, a jury agreed that Kokesh had fraudulently misappropriated the funds.⁸ The trial judge ordered Kokesh to disgorge \$34.9 million, which it found “reasonably approximates the ill-gotten gains causally connected to Defendant’s violations.”⁹

Because there is no statute of limitations explicitly applicable to disgorgement proceedings, the defendant argued that the generic federal five-year statute of limitations under 28 U.S.C. § 2462 applied.¹⁰ This statute applies to any “action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise,” for which Congress has not provided a specific statute of limitations.¹¹ Kokesh argued that disgorgement is a penalty or forfeiture within the meaning of section 2462 and, because the events in question had taken place more than five years previously, the statute time-barred the SEC action.¹²

6 The facts are drawn from the lower court opinion, *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016), *rev'd sub nom. Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

7 *See id.* at 1161 (“From 1995 through 2006, Defendant directed the Advisers’ treasurer to take \$23.8 million from the Funds to pay salaries and bonuses to officers of the Advisers (which included Defendant himself) and to take \$5 million to cover the Advisers’ office rent. In 2000 he also caused the Advisers to take \$6.1 million in payments described as “tax distributions” in SEC reports that he signed.”).

8 *See id.* (summarizing the jury verdicts).

9 *Id.*

10 *See id.* at 1162 (“Defendant argues that . . . the disgorgement order is a penalty or forfeiture within the meaning of § 2462.”).

11 28 U.S.C. § 2462.

12 Kokesh was also subject to a permanent injunction against “directly or indirectly violating section 206(1) and (2) of the Investment Advisers Act; section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-13; section 14(a) of the Exchange Act and Exchange Act Rule 14a-9; section 37 of the Investment Company Act, and Section 205(a) of the Investment Advisers Act.” *Id.* at 1162. He claimed that the injunction was also subject to the section 2462 limitation period. The Tenth Circuit dismissed that argument almost out of hand, observing that “[w]e fail to see how an order to obey the law is a penalty.” *Id.* Kokesh did not seek Supreme Court review of that aspect of the case. *See* Petition for Writ of Certiorari, *Kokesh v. S.E.C.*, 2016 WL 6124409 (U.S. 2016) (No. 16-529) (“The question presented is: Does the five-year statute of limitations in 28 U.S.C. § 2462 apply to

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The Tenth Circuit rejected that argument, holding that disgorgement is a remedy rather than a penalty, explaining that, “[p]roperly applied, the disgorgement remedy does not inflict punishment.”¹³ Although the Tenth Circuit agreed that “disgorgement serves a deterrent purpose,” the court further explained that “it does so only by depriving the wrongdoer of the benefits of wrongdoing.”¹⁴

The Supreme Court reversed in a unanimous opinion by Justice Sotomayor.¹⁵ Importantly, the Court went out of its way to note that disgorgement is a relatively new penalty that was created by judicial fiat at the SEC’s behest:

Initially, the only statutory remedy available to the SEC in an enforcement action was an injunction barring future violations of securities laws. . . . In the absence of statutory authorization for monetary remedies, the Commission urged courts to order disgorgement as an exercise of their “inherent equity power to grant relief ancillary to an injunction.”¹⁶

Somewhat later in the opinion the Court dropped a footnote (number three), stating that:

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. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to [section] 2462’s limitations period.¹⁷

The footnote is an apparent nod to the concerns several justices raised at oral argument about the scope of the SEC’s authority and the power of

claims for ‘disgorgement?’”).

13 *Kokesh*, 834 F.3d at 1164.

14 *Id.*

15 *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

16 *Id.* at 1640 (quoting *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff’d in part and rev’d in part*, 446 F.2d 1301 (2d Cir. 1971)) (citation omitted).

17 *Id.* at 1642 n.3.

courts with respect to disgorgement.¹⁸ Despite its seeming neutrality on the question, footnote three “all but invites [future] defendants to make a challenge” to the validity of the disgorgement sanction.¹⁹ After all, “when the Supreme Court says, ‘We’re not expressing an opinion on x,’ you can be pretty sure the justices are expressing an opinion on x.”²⁰

II. BACKGROUND

There is general agreement that the penalty phase of *Texas Gulf Sulphur*²¹ was the first time a court determined that the SEC had authority to seek disgorgement of a defendant’s ill-gotten gains.²² Securities Exchange Act section 27 gives district courts general equity powers in civil cases the SEC initiates.²³ In *Texas Gulf Sulphur*, however, defendants argued that section 21(e) only authorizes the SEC to seek injunctive relief against anyone who is “engaged or about to engage in any acts or practices

18 See *U.S. Top Court Questions SEC’s Powers to Recover Ill-Gotten Profits*, 23 No. 12 Westlaw Journal Derivatives 2 (2017).

19 Morris, *supra* note 5.

20 Sam Bray, *Equity at the Supreme Court*, VOLOKH CONSPIRACY (June 10, 2017), <https://www.washingtonpost.com/news/volokh-conspiracy/wp/2017/06/10/equity-at-the-supreme-court/>.

21 SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970), *aff’d in part, rev’d in part on other grounds*, 446 F.2d 1301 (2d Cir. 1971). The liability phase of *Texas Gulf Sulphur*, of course, was the first appellate decision imposing insider trading liability under Rule 10b-5. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); see generally SEC v. Nat’l Student Mktg. Corp., 457 F. Supp. 682, 703 (D.D.C. 1978) (describing *Texas Gulf Sulphur* as the “seminal case” in which the “Second Circuit held that liability for insider trading violations” arises under Rule 10b-5). In the liability phase *Texas Gulf Sulphur* decision, the Second Circuit remanded the case to the district court for a determination of what penalties and remedies were appropriate. See *Texas Gulf Sulphur Co.*, 401 F.2d at 842-43 (summarizing remand order). For a critique of the liability phase decision, see Stephen M. Bainbridge, *Bainbridge, Equal Access to Information: The Fraud at the Heart of Texas Gulf Sulphur* (UCLA School of Law, Law-Econ Research Paper No. 17-14, August 7, 2017), <https://ssrn.com/abstract=3014977>.

22 See, e.g., Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 320 (2008) (“SEC v. *Texas Gulf Sulphur Co.* was the first case in which an appellate court recognized the disgorgement remedy and required corporate insiders who traded on material nonpublic information to disgorge their illegal trading profits.”); Verity Winship, *Fair Funds and the SEC’s Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1112 n. 32 (2008) (“*Texas Gulf Sulphur* was the first case to determine that the court had the power to grant the ancillary relief of disgorgement, thereby depriving defendants of their profits from insider trading.”).

23 15 U.S.C.S. § 78aa (2017).

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which constitute or will constitute a violation” of the securities laws.²⁴ Accordingly, they claimed, the SEC lacked authority to seek additional equitable relief.²⁵ The Second Circuit disagreed, holding “that the SEC may seek other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and is not a penalty assessment.”²⁶ The court, further rejecting the defendants’ argument that disgorgement acts as a penalty, authorized the SEC to seek disgorgement and courts the power to grant it.²⁷

Why is the SEC’s authority to seek ancillary equitable remedies limited by the requirement that they not be penalties? In short, because courts of equity lack competence to impose civil penalties: “Remedies intended to punish culpable individuals, as opposed to those intended simply to extract compensation or restore the status quo, were issued by courts of law, not courts of equity.”²⁸ In other words, penalties are legal rather than equitable sanctions.²⁹ As such, section 21’s grant of authority to the SEC to seek injunctive relief and section 27’s grant of power to the courts to exercise equitable jurisdiction are inapposite for penalties.³⁰ Instead, there must be an express grant of statutory authority to seek disgorgement as a legal sanction,³¹ and, at the time *Texas Gulf Sulphur* was decided, no such statutory authority existed.³²

Although a number of subsequent congressional enactments touch on a

24 *Texas Gulf Sulphur*, 446 F.2d at 1307. *See also* SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989) (holding that “disgorgement may not be used punitively”).

25 *Texas Gulf Sulphur*, 446 F.2d at 1307 (“Appellants contend that, although the district court is given general equity powers under [section] 27 of the Act, the SEC does not have authority under the Act to seek anything but injunctive relief under [section] 21(e), together with whatever ancillary relief is necessary to enforce an injunction, such as the appointment of a receiver.”).

26 *Texas Gulf Sulphur*, 446 F.2d at 1308.

27 *See infra* text accompanying note 45.

28 *Tull v. United States*, 481 U.S. 412, 422 (1987).

29 *See* Bray, *supra* note 20 (stating that “there are no penalties in equity”).

30 Samuel L. Bray, *The Supreme Court and the New Equity*, 68 VAND. L. REV. 997, 1053 (2015). The point is significant because courts continue to draw a sharp line between law and equity. *See id.* (noting that “the expected demise of the line between legal and equitable remedies has not occurred. Instead, the U.S. Supreme Court’s new equity cases have preserved that line and the doctrines that constitute it”).

31 *See, e.g.*, *Am. Bus. Assn. v. Slater*, 231 F.3d 1, 8 (D.C. Cir. 2000) (Sentelle, J., concurring). (“Congress’s failure to grant an agency a given power is not an ambiguity as to whether that power has, in fact, been granted. On the contrary, and as this Court persistently has recognized, a statutory silence on the granting of a power is a *denial* of that power to the agency.”).

32 David Zaring, *Enforcement Discretion at the SEC*, 94 TEX. L. REV. 1155, 1219 n.263 (2016).

disgorgement legal sanction, none are dispositive. Sections 202 and 203 of Securities Enforcement Remedies and Penny Stock Reform Act of 1990 authorize the SEC to seek disgorgement in administrative proceedings, but do not settle the question of whether disgorgement sounds in law or equity.³³ Section 304(a) of the Sarbanes-Oxley Act of 2002 (SOX)³⁴ and section 954 of the Dodd-Frank Act of 2010³⁵ provide for issuers to clawback executive compensation under certain circumstances when the company has restated its financials. The clawback remedy, however, is only weakly analogous to disgorgement and, in any event, does not settle the question at hand. SOX section 305(b) authorizes federal courts to grant “any equitable relief that may be appropriate or necessary for the benefit of investors,”³⁶ but that provision obviously does not settle the status of disgorgement.

Congress has also amended Securities Exchange Act section 21 to empower courts to impose three tiers of penalties for most securities violations. The first tier authorizes a penalty of up to the greater of \$5,000 (for natural persons) or the “gross amount” of the defendant’s “pecuniary gain.”³⁷ Tier two authorizes a penalty of up to the greater of \$50,000 (for natural persons) or the “gross amount” of the defendant’s “pecuniary gain.”³⁸ Tier three authorizes a penalty of up to the greater of \$100,000 (for natural persons) or the “gross amount” of the defendant’s “pecuniary gain.”³⁹ Each tier thus permits a penalty that is effectively identical to disgorgement. Again, however, nothing in this provision address the

33 Pub. L. No. 101-429, §§ 202(a), 203, 104 Stat. 931, 937-39 (2002) (codified at 15 U.S.C. §§ 78u-2(e), 78u-3(e)).

34 Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2002) (codified at 15 U.S.C. § 7243).

35 Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

36 Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2002).

37 15 U.S.C. § 78u(d)(3)(B)(i).

38 15 U.S.C. § 78u(d)(3)(B)(ii). “In the second tier, where the violation ‘involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement,’ the penalty cannot exceed the greater of (a) \$60,000, or (b) the gross amount of pecuniary gain to the defendant as a result of the violation.” *S.E.C. v. Colonial Inv. Mgmt. LLC*, 659 F. Supp. 2d 467, 502–03 (S.D.N.Y. 2009), *aff’d*, 381 F. App’x 27 (2d Cir. 2010).

39 15 U.S.C. § 78u(d)(3)(B)(iii). The third “tier applies if the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and the violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to others.” Barry W. Rashkover, *Fundamentals of SEC Enforcement Defense Practice Outline of Investigative and Remedies Issues*, 20110311A NYCBAR 698 (2011).

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question at hand.

Although none of these provisions expressly authorizes the judicially-created disgorgement sanction,⁴⁰ they may be cited as evidence that the reenactment doctrine validates that sanction.⁴¹

Under this doctrine, long standing court or agency interpretations of a statute are deemed to have been approved by Congress if the statute to which they apply are reenacted by Congress unchanged. When this occurs, those interpretations have the force of law and can only be changed by Congress.⁴²

However, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,⁴³ which involved the scope of the implied private cause of action under Rule 10b-5, the Supreme Court held that because “Congress has not reenacted the language of [section] 10(b) since 1934” the Court “need not determine whether the other conditions for applying the reenactment doctrine are present.”⁴⁴ None of the congressional enactments discussed above reenacted section 10(b) (or any other relevant provisions of the securities laws under which disgorgement has been ordered, for that matter). The reenactment doctrine thus cannot replace the missing statutory authorization for disgorgement. If disgorgement is to survive as a sanction in insider trading and other SEC cases, it must therefore be characterized as equitable so as to fall within the powers granted the SEC and the courts under sections 21 and 27 of the Securities Exchange Act.

40 See Francesco A. DeLuca, *Sheathing Restitution's Dagger Under the Securities Acts: Why Federal Courts Are Powerless to Order Disgorgement in Sec Enforcement Proceedings*, 33 REV. BANKING & FIN. L. 899, 907 (2014).

41 In addition, the legislative history of various provisions has occasionally referred with seeming approval to the disgorgement sanction. See, e.g., H.R. Rep. No. 355, at 8 (1983) (stating that, “in appropriate insider trading cases, the Commission may seek . . . disgorgement of ill-gotten gains”); 150 CONG. REC. S5191-02 (2004). (“In the special case of insider trading, violations result in 100 percent disgorgement plus a civil fine of up to 300 percent, for a total civil penalty equal to 400 percent.”). Notice that in the latter case, however, Senator Levin referred to disgorgement as a penalty.

42 *Ward v. C.I.R.*, 784 F.2d 1424, 1430 (9th Cir. 1986).

43 *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

44 *Id.* at 185.

III. IS DISGORGEMENT A LEGAL PENALTY OR AN EQUITABLE REMEDY?

The *Texas Gulf Sulphur* court concluded that disgorgement was not a penalty because it “merely deprives” wrongdoers “of the gains of their wrongful conduct.”⁴⁵ The court also rejected defendants’ argument that disgorgement in this context was punitive because there was no guarantee the money would go to persons who had traded with the defendants. The court noted, for example, the potential that at least some of the disgorged funds might end up being paid to defendants’ former employer to compensate for harm to its reputation.⁴⁶

In contrast, the Supreme Court in *Kokesh* concluded that disgorgement is a penalty for three reasons:

1. In cases brought by the SEC, as opposed to those brought by private parties, disgorgement is intended to remedy a harm to the public at large rather than to recompense specific victims.⁴⁷
2. The primary purpose of SEC-initiated disgorgement proceedings is to deter securities fraud rather than to compensate injured parties.⁴⁸
3. The proceeds of SEC-initiated disgorgement proceedings often go to the government, thus operating as a penalty.⁴⁹

Accordingly, the Court concluded, “SEC disgorgement . . . 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.”⁵⁰

In addition, the Court rejected the government’s argument that disgorgement is remedial because it simply puts the defendant back in the

45 SEC v. *Texas Gulf Sulphur*, 446 F.2d 1301,1308 (2d Cir. 1971).

46 *Id.*

47 *Kokesh v. SEC*, 137 S. Ct. 1635, 1643 (2017).

48 *Id.*

49 *Id.* at 1644.

50 *Id.*

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position “he would have occupied had he not broken the law.”⁵¹ In fact, disgorgement often leaves the defendant worse off than he would have been had he not broken the law: The way disgorgement is measured by courts can result in the defendant’s penalty exceeding the economic measure of his profit.⁵² Further, although common law allows a defendant to mitigate the amount to be disgorged by taking into account his expenses, SEC disgorgement penalties often do not.⁵³

The Court’s analysis is not a paragon of legal reasoning. First, the Court’s three affirmative reasons for treating disgorgement as a penalty basically amount to repeating the point that disgorgement is not always compensatory. Yet, as the Court acknowledged, the proceeds of many disgorgement proceedings ultimately are paid over to the victims of the fraud rather than the U.S. Treasury.⁵⁴ Second, the Court failed utterly to grapple with the considerable body of law upon which the U.S. Court of Appeals for the Tenth Circuit had relied in finding that disgorgement is not a penalty within the meaning of section 2462.⁵⁵

IV. IS DISGORGEMENT ALWAYS A LEGAL PENALTY?

Characterizing disgorgement as a penalty for purposes of section 2462,

⁵¹ *Id.*

⁵² *See id.* (“SEC disgorgement sometimes exceeds the profits gained as a result of the violation.”).

⁵³ *Id.*

⁵⁴ *See id.* at 1645 (“True, disgorgement serves compensatory goals in some cases . . .”).

⁵⁵ *See* SEC v. *Kokesh*, 834 F.3d 1158, 1164-67 (10th Cir. 2016) (discussing authorities), *rev’d sub nom.* *Kokesh v. SEC*, 137 S. Ct. 1635 (2017). In addition, the Supreme Court’s opinion wholly ignored the much stronger argument that disgorgement in this context operates as a forfeiture, which would also subject such proceedings to section 2462. In the lower court, the Tenth Circuit had been forced to acknowledge that, as a matter of plain English, the two words “capture similar concepts.” *Kokesh*, 834 F.3d at 1165. It also acknowledged the Eleventh Circuit recently had concluded that disgorgement was a forfeiture within the meaning of section 2462. This approach to the problem thus offered a much more plausible solution. *See generally* Jon Eisenberg, *Is Disgorgement a “Forfeiture” for Statute of Limitations Purposes?* HARV. L. SCH. FORUM ON CORP. GOV. & FIN REG. (Mar. 14, 2017), <https://corpgov.law.harvard.edu/2017/03/14/is-disgorgement-a-forfeiture-for-statute-of-limitations-purposes/>. (concluding that “the commonly-understood meaning of ‘forfeiture,’ the importance of the policies underlying statutes of limitations, the absence of any basis for distinguishing between fines and disgorgement in terms of the policies underlying statutes of limitations, the compelling reasons to limit remedies first created by courts rather than Congress, the punitive effects of disgorgement on defendants, and even a reasonable definition of ‘penalty’ support applying [section] 2462 to SEC disgorgement actions”).

as *Kokesh* did, is not necessarily dispositive. In a future case, the Supreme Court could decide that disgorgement is an equitable remedy for some purposes and a legal penalty for others.⁵⁶ For example, although there is no constitutional requirement that all laws have a statute of limitations,⁵⁷ the Court might explain that there are important fairness and justice issues that distinguish the limitations question from the authority issue.⁵⁸ There are additional reasons to doubt the continuing validity of disgorgement, however.

First, all of the Court's arguments about the nature of disgorgement apply with equal force to the issue of SEC authority and judicial power as they do to that of statutes of limitation. Disgorgement as practiced in SEC proceedings acts as a punitive sanction intended to deter, regardless of whether we are considering applicable statutes of limitation or the authority and power issues. Likewise, nothing about shifting the frame of analysis from the limitations period to the authority and power perspective changes the basic fact that disgorgement as used in SEC cases is intended to remedy a harm to the public rather than to compensate specific victims. There is no hook in the opinion for distinguishing the two contexts. Declaring that disgorgement is punitive for purposes of the statute of limitations but not for other purposes thus would require a blatant exercise of naked judicial fiat.

Second, as we saw above, Securities Exchange Act section 21 permits the SEC to seek and courts to award penalties that are the functional equivalent of disgorgement.⁵⁹ These provisions thus raise the question of

56 See Dennis J. Wiley, *Enforcing Recoupment Provisions After Great-West Life & Annuity Insurance Company v. Knudson: A Suggested Method of Analysis for Reviewing Courts*, 9 DEPAUL J. HEALTH CARE L. 1195, 1203 (2006); Doug Rendleman, *Irreparability Irreparably Damaged*, 90 MICH. L. REV. 1642, 1648 (1992) ("Characterization as legal or equitable, if necessary for one purpose, need not carry over to others.").

57 See, e.g., *Chase Sec. Corp. v. Donaldson*, 325 U.S. 304, 314 (1945) ("Their [statutes of limitations'] shelter has never been regarded as what now is called a 'fundamental' right or what used to be called a 'natural' right of the individual. He may, of course, have the protection of the policy while it exists, but the history of pleas of limitation shows them to be good only by legislative grace and to be subject to a relatively large degree of legislative control.").

58 Indeed, in *Kokesh* itself, the Court noted that "[s]tatutes of limitations 'se[t] a fixed date when exposure to the specified Government enforcement efforts en[d].'" Such limits are 'vital to the welfare of society' and rest on the principle that 'even wrongdoers are entitled to assume that their sins may be forgotten.'" *Kokesh v. SEC*, 137 S. Ct. 1635, 1641 (2017).

59 See *supra* text accompanying notes 37-39.

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whether courts should continue to impose a sanction unauthorized by statute when an equivalent sanction has been so authorized.⁶⁰ This question is especially pertinent because the logic of the *Texas Gulf Sulphur* decision and its progeny is closely akin to the logic of the early Supreme Court decisions creating implied private rights of action under the securities laws.⁶¹ The latter category of decisions, however, no longer have the vitality they possessed when *Texas Gulf Sulphur* was decided. The late Justice Powell argued forcefully that judicial creation of such rights:

allows the Judicial Branch to assume policymaking authority vested by the Constitution in the Legislative Branch. It also invites Congress to avoid resolution of the often controversial question of whether a new regulatory statute should be enforced through private litigation. Rather than confronting the hard political choices involved, Congress is encouraged to shirk its constitutional obligation and leave the issue to the courts to decide. When this happens, the legislative process with its public scrutiny and participation has been bypassed, with attendant prejudice to everyone concerned.⁶²

Other justices seem to have been persuaded by such concerns, because in recent years the “Supreme Court has been extremely reluctant to expand previously-recognized implied private rights of action or to recognize ‘new’ implied private rights of action.”⁶³ By undermining the precedents upon which *Texas Gulf Sulphur* relied, this line of Supreme Court cases thus necessarily also calls the continuing validity of disgorgement into

60 *Cf.* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994) (“The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.”).

61 *See* Note, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188, 1190 (1975) (noting that *Texas Gulf Sulphur* relied in part on “decisions under the securities acts clarifying the scope of remedies in favor of private litigants”); *see also* Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1254 (1995) (“The Supreme Court for many years was in the business of expanding the scope of securities liability through the ready creation and broad interpretation of the implied private rights of actions.”).

62 *Cannon v. University of Chicago*, 441 U.S. 677, 743 (1979) (Powell, J., dissenting).

63 *Ciliv v. UXB Int'l, Inc.*, No. 7:12-CV-290, 2012 WL 5245323, at *4 (W.D. Va. Oct. 22, 2012)

question.⁶⁴

Finally, when considered in light of Supreme Court teaching on the scope of the federal courts' equity jurisdiction, the history of the disgorgement remedy suggests that it is not a valid part of that jurisdiction. The leading precedent is *SEC v. Cavanagh*,⁶⁵ in which the Second Circuit correctly recognized that federal courts' "equity jurisdiction . . . 'is an authority to administer in equity suits the principles of the system of judicial remedies [recognized by the] English Court of Chancery at the time of the separation of the two countries.'"⁶⁶ This presented the Second Circuit with a problem. As the Supreme Court would later note in *Kokesh*, disgorgement is a relatively new remedy.⁶⁷ The Second Circuit attempted to avoid that problem—and thereby to uphold disgorgement as valid within the scope of federal courts' equity jurisdiction—by analogizing disgorgement to remedies that did exist in 1789.

First, the *Cavanagh* opinion equated disgorgement to the equitable remedy known as accounting, "by which chancery ordered an accounting of assets so that wrongly gained profits might be recovered."⁶⁸ However, the analogy does not hold water. Accounting was a remedy only available against persons who has breached a fiduciary duty—a court could not order this remedy against a mere wrongdoer.⁶⁹

64 On the other hand, defenders of disgorgement may argue that it is an established remedy that needs neither expansion nor creation and, as such, is not dispositively undermined by the trends in implied private rights of action. When one couples Justice Powell's concerns with bypassing the legislative process with the congressional adoption of penalties that are the functional equivalent of disgorgement, and the fact that the Supreme Court has never explicitly endorsed disgorgement, this argument has little traction.

65 445 F.3d 105 (2d Cir. 2006).

66 *Id.* at 117 (quoting *Grupo Mexicano de Desarrollo S.A. v. All. Bond Fund, Inc.*, 527 U.S. 308, 318 (1999)).

67 See *supra* text accompanying note 16.

68 *Cavanagh*, 445 F.3d at 119.

69 See DeLuca, *supra* note 40, at 915 (arguing that "the fiduciary-wrongdoer distinction not only damages *Cavanagh's* analogy between the two remedies but also undermines *Cavanagh's* entire mission"). It is true, of course, that liability for insider trading is premised on fiduciary or similar relationship of trust and confidence. *Simon DeBartolo Grp., L.P. v. Richard E. Jacobs Grp., Inc.*, 186 F.3d 157, 171–72 (2d Cir. 1999). The same is not true of other securities violations for which disgorgement may be imposed as a remedy, because it may be imposed against wrongdoers generally. See, e.g., *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997) ("As an exercise of its equity powers, the court may order wrongdoers to disgorge their fraudulently obtained profits."). In addition, there are various circumstances in which insider trading liability is imposed even in the absence of a fiduciary relationship. See STEPHEN M. BAINBRIDGE, *INSIDER TRADING LAW AND POLICY* 168-74

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Kokesh Footnote Three Notwithstanding

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Second, the *Cavanagh* opinion analogized disgorgement to a constructive trust.⁷⁰ Again, however, the analogy fails. One type of constructive trust is used so that beneficiaries may recover from assets purloined by a fiduciary, as well as any gains traceable to their use, which is inapt with respect to insider trading.⁷¹ The other type of constructive trust, which is used as a remedy for unjust enrichment, did not exist in 1789.⁷²

Finally, the *Cavanagh* opinion analogized disgorgement to restitution.⁷³ Once more, the analogy is flawed. Restitution is a generic term that can be characterized as legal or equitable depending on the nature of the claim and the relief being sought.⁷⁴ As a result, “the analogy to ‘restitution’ is circular and unhelpful.”⁷⁵

In addition, all three of the *Cavanagh* analogies are compensatory remedies. The primary purpose of disgorgement in SEC cases, however, is deterrence.⁷⁶ Accordingly, the amount a defendant must disgorge need not be the same as the loss suffered by the victims of defendant’s misconduct and, more importantly, disgorgement may be ordered even if none of the funds will be paid out to harmed investors.⁷⁷ All of the analogies offered by the *Cavanagh* court thus are inapt.

In sum, as my former colleague Sam Bray observes:

There is no equitable remedy of disgorgement. There are a number of equitable remedies that are restitutionary, such as the constructive trust, accounting for profits and equitable lien. . . . But

(2014) (identifying such circumstances).

⁷⁰ *Cavanagh*, 445 F.3d at 119.

⁷¹ See DeLuca, *supra* note 40, at 917 (describing an institutional constructive trust).

⁷² *Id.* at 918-919.

⁷³ *Cavanagh*, 445 F.3d at 119.

⁷⁴ Reich v. Continental Casualty Co., 33 F.3d 754, 756 (7th Cir. 1994) (explaining that “restitution is a legal remedy when ordered in a case at law and an equitable remedy . . . when ordered in an equity case”).

⁷⁵ DeLuca, *supra* note 40, at 920.

⁷⁶ See, e.g., SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) (“The primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains.”); SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987) (“The paramount purpose of . . . ordering disgorgement is to make sure that wrongdoers will not profit from their wrongdoing.”).

⁷⁷ See *Fischbach Corp.*, 133 F.3d at 176 (holding that “the measure of disgorgement need not be tied to the losses suffered by defrauded investors . . . and a district court may order disgorgement regardless of whether the disgorged funds will be paid to such investors as restitution”).

“disgorgement” isn’t one of those remedies. The word does not even appear in Pomeroy’s treatise on equity In older sources, the verb *disgorge* is occasionally used, and more rarely disgorgement will be used as a nontechnical term (cf. the cognates repay and repayment). Maybe “disgorgement” is a good term for a sui generis restitutionary remedy created by statute. But there is no equitable or common law remedy of “disgorgement.”⁷⁸

As a result, it will require quite a feat of judicial legerdemain for the Supreme Court to validate disgorgement when the issue next comes before it.

CONCLUSION

Texas Gulf Sulphur and its progeny base the SEC’s authority to seek and the court’s power to impose disgorgement on the claim that it is a form of equitable ancillary relief. If disgorgement is a penalty, however, courts lack that power and the SEC lacks that authority. This conclusion follows necessarily from the basic premise that there are no penalties in equity and the complete absence of any statutory authority to impose disgorgement as a legal sanction.

The Supreme Court has now made clear that disgorgement is, in fact, a penalty. Although not dispositive of the question, when coupled with the other reasons to doubt the validity of the disgorgement sanction, the future of the disgorgement penalty therefore looks bleak, notwithstanding the disclaimer in *Kokesh* footnote three.

78 Bray, *supra* note 20.