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In *Kokesh v. SEC*, the U.S. Supreme Court Held that SEC Disgorgement Is a "Penalty", with Consequences for Both SEC Enforcement Actions and Corporate Taxpayers

June 7, 2017

EXECUTIVE SUMMARY

This week's unanimous U.S. Supreme Court decision in *Kokesh v. Securities and Exchange Commission* is important for both SEC enforcement actions and for tax reasons:

- First, the Court's holding that disgorgement in SEC enforcement actions is a "penalty" for purposes of the five-year statute of limitation in 28 U.S.C. § 2462 will impair the SEC's pre-existing position that disgorgement claims have no time limitation, requiring the SEC to file a complaint more quickly, or secure a tolling agreement, within five years of the conduct for which disgorgement is sought.
- Second, while *Kokesh* is not a tax case, the U.S. tax code's denial of a deduction for a "fine or similar penalty" is likely to make disgorgement nondeductible in SEC enforcement cases, and perhaps in other cases as well.

DISCUSSION

On June 5, the U.S. Supreme Court issued a unanimous ruling in *Kokesh v. Securities and Exchange Commission* holding that disgorgement in SEC enforcement actions is a "penalty" for purposes of the relevant five-year statute of limitations. As a result, a large portion of a disgorgement award was time-barred. This holding will cause the SEC to pay close attention to the timeliness of its investigations and actions and make tolling agreements a more significant issue for those subject to investigation. Although Kokesh concerns disgorgement against an individual and is not a tax case, it nevertheless will have significant implications for corporate taxpayers relating to the deductibility of disgorgement payments.

In *Kokesh*, the SEC brought an enforcement action for the violation of certain securities laws and won a $34.9 million disgorgement judgment in the U.S. District Court. A five-year statute of limitations applies to any action seeking a "civil fine, penalty, or forfeiture, pecuniary or otherwise", and the issue in *Kokesh* was whether that statute of limitations applied to disgorgement imposed in an SEC enforcement case. (The financial consequences were significant: $30 million of the $34.9 million disgorgement award related to conduct outside the five-year limitations period.) The U.S. District Court ruled that a five-year statute of limitations for penalties and forfeiture did not apply to the disgorgement, and the U.S. Court of Appeals for the Tenth Circuit affirmed. Petitioner appealed to the Supreme Court, which accepted the case in order to resolve a circuit split on the legal issue of whether the five-year statute of limitations applies to disgorgement in SEC enforcement actions.

The procedural issue in *Kokesh* is relevant for U.S. Federal income tax purposes. Under Section 162(a) of the Internal Revenue Code of 1986, as amended (the "Code"), amounts paid by a corporation to settle claims or satisfy judgments arising out of business conduct are generally deductible. One important exception, however, is found in Section 162(f), which denies a deduction for a payment of a "fine or similar penalty" to a government. Not all payments to a government are fines or similar penalties; the Treasury Regulations make clear that compensatory damages paid to governments are not subject to Section 162(f) and, therefore, are deductible. Given the U.S. corporate tax rate of 35%, the stakes are high; deductions are often quite valuable and can lessen the financial impact of a large judgment or settlement.

Prior to *Kokesh*, it was unclear how certain payments to governments, such as disgorgement in SEC cases, might be classified for tax purposes. Disgorgement is an equitable remedy frequently sought by the SEC. It is designed to prevent unjust enrichment and deter wrongdoing by taking from the wrongdoer the fruits of its improper activities and returning the wrongdoer to the *status quo ante*. Because the wrongdoer is, at least in theory, no worse off than if it had not engaged in misconduct, many courts and other legal authorities in tax cases have analyzed disgorgement payments as remedial—not punitive—and therefore deductible. In other cases, disgorgement has been held to be punitive because of its retributive character—and therefore not deductible because it is a "fine or similar penalty" under Section 162(f).

In *Kokesh* the Supreme Court took a categorical approach and held that the statute of limitations applied because "SEC disgorgement constitutes a penalty." In its analysis, the Court stated that whether a particular sanction is a penalty requires an inquiry into its purpose. If the sanction is intended to compensate victims of conduct, it is not a penalty. On the other hand, if it is intended to punish or deter others from engaging in certain conduct, it is a penalty.

In the case of SEC enforcement actions, the Court seemed particularly swayed by its observation that the violation was committed against the United States and not against a particular "aggrieved individual". The Court also acknowledged that disgorgement could, in some cases, be compensatory in part, noting that "sanctions frequently serve more than one purpose." Nevertheless, the Court found that a disgorgement action is punitive where it "cannot fairly be said *solely* to serve a remedial purpose" (emphasis in original) and "can only be explained as also serving either retributive or deterrent purposes". Therefore, the Court found disgorgement to be a penalty within the meaning of the statute of limitations, stating, "SEC disgorgement thus bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate."

Kokesh will make it very difficult, if not impossible, for taxpayers to argue that disgorgement paid in SEC enforcement actions is not a "fine or similar penalty" within the meaning of Section 162(f) of the Code. Possibly this argument could be made in situations where the disgorgement funds are specifically designated for distribution to injured parties. However, the broad language of *Kokesh* concerning payments made for more than one purpose will make even this argument very challenging. As a result, in most cases SEC disgorgements will not be deductible.

Deductions for disgorgement payments outside of the SEC enforcement context are also at serious risk. *Kokesh* does not address other disgorgement payments specifically, but the Court's opinion will lend strong support to an IRS assertion that all disgorgement is punitive, at least in part, and therefore is a nondeductible penalty. Taxpayers facing government investigations of all kinds will now be forced to negotiate disgorgement settlements—and make disgorgement payments—with a significant risk that the payment will be made with after-tax dollars.

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