Q&A: What Disgorgement Means For You

The US Supreme Court in June limited the US Securities and Exchange Commission's (SEC) ability to recover disgorgement by alleged violators of federal securities law. For decades, the SEC sought these disgorgements going back indefinitely. However, in a unanimous 9-0 decision in Kokesh v. SEC, the Supreme Court said that SEC disgorgement claims are subject to a five-year statute of limitations period. Although the Supreme Court's ruling resolved this specific issue, it also laid the groundwork for future challenges to SEC disgorgement actions. Writing for the Court, Justice Sonia Sotomayor expressly reserved judgment on whether the SEC is entitled to recover disgorgement under any circumstances. Such fundamental questioning of the SEC's authority provides an opportunity to assess the enforcement landscape and the practical implications of the Supreme Court's Kokesh decision.

In the following Q&A, Machua Millett of Marsh and Nicolas Morgan of law firm Paul Hastings LLP discuss the decision and its impact on future investigations.

NICOLAS MORGAN

Partner in the investigations and white collar defense practice, Paul Hastings LLP

Q: Even before the Supreme Court's decision in Kokesh, many pundits had predicted that US federal enforcement activity in general, and SEC enforcement specifically, would decrease under the new administration of President Donald Trump. Have you seen that play out?

A: Not yet. Historically, enforcement activity has generally not been tied to an administration change. Rather, events that create strains on the SEC's resources to address a small number of cases, such as following the financial crises, tend to reduce the overall activity. Otherwise, SEC staff operate fairly routinely, regardless of who is in the White House.

Q: In practical terms, what do you think the Supreme Court's decision means for those companies already involved in SEC investigations or proceedings?

A: For most companies, not much. The SEC already operates under a five-year statute of limitations for penalties. And when that deadline draws near, the SEC normally asks for a tolling agreement. Those same tolling agreements will apply

to disgorgement. Companies negotiating settlements should understand when the disgorgement amounts arose and insist on excluding any that may be barred by the five-year statute of limitations.

Q For those evaluating the potential risk and cost of SEC enforcement going forward, do you see this decision reducing the SEC's motivation to bring investigations and proceedings, or just the amounts they can potentially recover?

At the margins, the SEC will likely obtain less in some settlements and may shy away from older cases where the Kokesh decision makes a disgorgement recovery unlikely. However, because a five-year statute of limitations already applies to penalties, the same disincentive to investigate stale cases already exists. The decision will only make such cases less attractive for the SEC to pursue.

Q: Any takeaways for SEC registrants regarding regulatory compliance in general and SEC disclosures, exams, investigations, and proceedings?

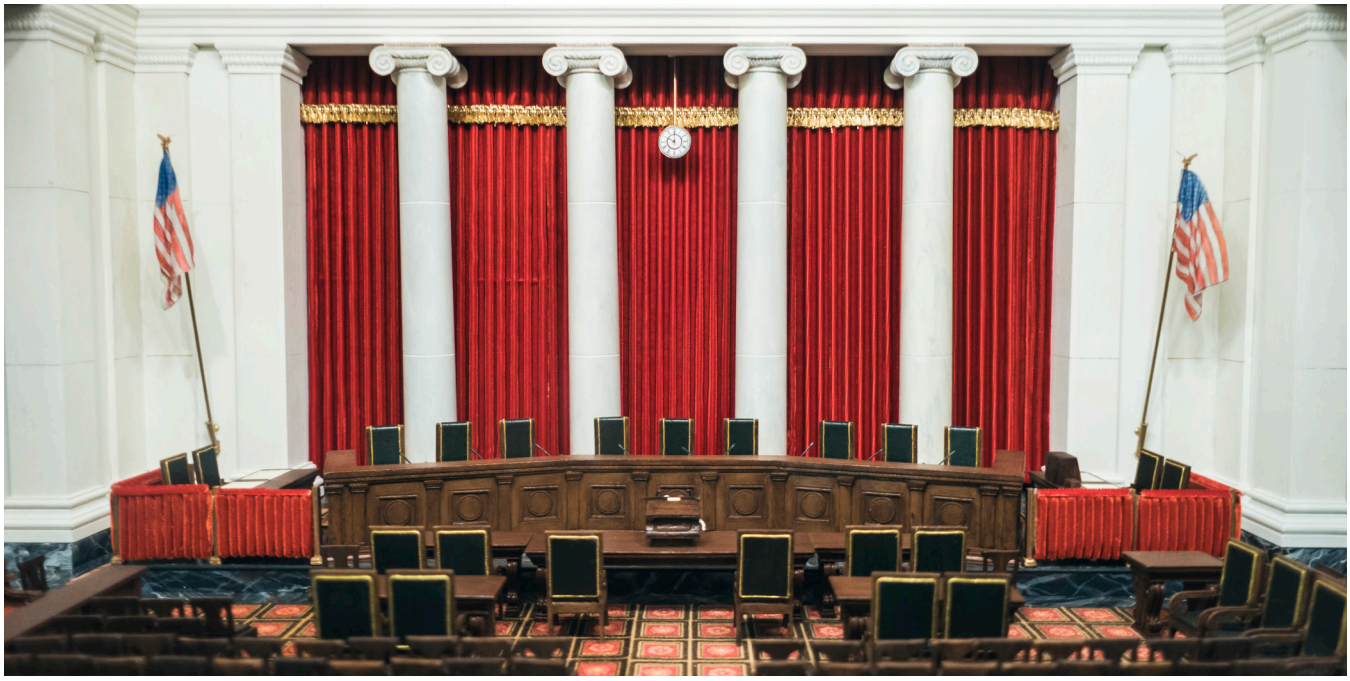
A: Even if you think your conduct is legal and proper, pay particular attention if the SEC suggests otherwise. The SEC expresses its opinions about the law in many ways. Make sure to look out for Office of Compliance Inspections and Examinations (OCIE) communications, Division of Corporate Finance correspondence, and other guidance and interpretations.

Q: Do you see any relevance in the decision to other areas of federal enforcement from agencies like the Department of Justice (DOJ), Environmental Protection Agency (EPA), Federal Communications Commission (FCC), Food and Drug Administration (FDA), or others?

A: Some obvious parallels are with federal agencies that pursue equitable disgorgement claims, such as the Federal Trade Commission (FTC), Consumer Financial Protection Bureau (CFPB), and Commodity Futures Trading Commission (CFTC). They will likely be bound by this decision. In terms of SEC disgorgement, the Internal Revenue Service (IRS) determined in 2016 that disgorgement paid to the SEC was a nondeductible "fine or penalty."

Q: The SEC has long benefited from a tendency among registrants to settle with the agency rather than fight and face the consequences of potentially losing. Could this decision motivate more registrants to fight the SEC in other areas?

A: There are often very good reasons for parties to settle with the SEC, but the Supreme Court's decision may embolden some SEC opponents to



question the legitimacy of the SEC's legal positions and fight the case.

Q: What other upcoming Supreme Court cases could affect the SEC's enforcement powers?

A: One issue is the SEC's use of administrative proceedings, which were expanded by the Dodd–Frank Wall Street Reform and Consumer Protection Act. Administrative proceedings typically are faster and do not have juries or the same evidentiary protections and discovery rights for defendants as federal courts. Because appellate courts have split on whether the use of administrative proceedings is constitutional, we'll likely see the Supreme Court weigh in. Interestingly, the federal appeals court that ruled in the SEC's favor on the statute of limitations issue in Kokesh ruled against the SEC on the constitutionality of its use of administrative proceedings. Stay tuned.

MACHUA MILLETT

Managing director and chief innovation officer and general partner liability product leader, Marsh's Financial and Professional Liability Practice

Q: How will the Supreme Court's decision affect insurance coverage disputes arising out of SEC investigations and litigation?

A: The securities defense and plaintiffs' bars often interpret major court decisions differently. Expect to see a dichotomy between policyholder's counsel and advocates and insurers and their counsel. This may result in the resurgence of some disputes that had largely (but not entirely) been resolved and contention between insurers and insureds over previously resolved disputes. It remains to be seen how the decision might impact policy language and coverage determinations; the players will adjust based upon respective leverage, expertise, and creativity.

Q: How might policy language evolve in reaction to the decision?

A: Knowledgeable brokers and counsel will continue to push for broader, more specific, and less ambiguous coverage for the various exposures that insureds face in this area. Insurers will likely decide on an individual basis what they are willing to cover and at what premium and retention. Intense competition between insurers in recent years, coupled with pressure from insureds and their advisors, has driven a constant expansion of coverage, low retentions, and low premiums. Coverage is expected to continue expanding as insurer competition shows no signs of waning.

Q: In the context of SEC enforcement, what are the biggest areas of dispute between insurers and insureds?

A: There can be friction on many aspects of coverage for SEC investigations. This is due in part to a lack of transparency and predictability of the SEC's investigation techniques and imposed consequences, and the tremendous defense costs that can be incurred when responding to such investigations. Where coverage issues begin and end often depend on the specific policy language and the relationship between the insured, insurer, and broker. Policy language can vary as to whether coverage explicitly or implicitly exists for defense costs, disgorgement, fines and penalties, and/or pre-judgment interest. Depending on the industry at issue, the policy language, and insurer relationship, some level of coverage for all, some, or none of those elements may exist.

Q: How common is it for policies to explicitly cover disgorgement as a "loss"?

A: It is important to distinguish between "disgorgement" — a term sometimes referring to "damages," "payments for amounts actually received by or passed on to others," or "a penalty" — and true disgorgement of amounts actually wrongfully received by an insured. Few, if any, policies explicitly cover true disgorgement. Many policies have an explicit exclusion for such true disgorgement (for example, the return of ill-gotten gains) if determined by a final non-appealable adjudication in the underlying proceeding. But if the disgorgement payment does not actually represent the return of ill-gotten gains, but instead an amount more appropriately understood as damages or something else, that exclusion does not apply. The discussion then turns to whether the amount at issue constitutes a loss, is insurable (and what law applies to make that determination), and whether fines and penalties are covered. All of this can be the subject of policy language negotiations in advance of a claim developing and significant disputes if the policy language is not clear when the claim arises.

Q: How might the Kokesh decision be reconciled with the line of cases stemming from Judge Posner's famous 2001 decision in Level 3 Communications in which he said, "An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return."

A: In my experience, these situations are never as simple as Judge Posner's quoted language above might indicate. I think the reality is that insurers and insureds will each make their arguments as to how these cases should be understood. Each side is likely to see some lower court decisions in the coming years that support their interpretations, and the majority of coverage dispute resolutions will continue to happen outside the courts and come down to the quality of the policy language negotiated by the insured and its advisors and the strength of the business relationship between the policyholder, the insurer, and the insured. Kokesh may have changed the coverage landscape somewhat; those who can adjust quickly may see better outcomes.

For more information on this topic and others, contact:

MACHUA MILLETT

+1 617 385 0308
machua.millett@marsh.com

NICOLAS MORGAN

+1 213 683 6181
nicolasmorgan@paulhastings.com