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WHITE-COLLAR CRIME

Expert Analysis

SEC's Possible Reality: all Enforcement Actions Filed Within Five Years

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The Securities and Exchange Commission's Division of Enforcement is charged with investigating and prosecuting violations of the federal securities laws. The agency is given vast resources to accomplish this task, and Congress and the courts have made clear that they expect it to act promptly in accomplishing its mission. Enforcement actions seeking penalties long have been subject to the five-year statute of limitations set forth in 28 U.S.C. §2462. For years, the SEC sought to not be tied down by a strict five-year limitation by arguing that the clock does not start to run until the alleged fraud is discovered by the agency—a position flatly rejected by the U.S. Supreme Court last year.[1]

The last arrow in its quiver to avoid the five-year statute has been its argument that when it seeks so-called "equitable" remedies, like injunctions and disgorgement, the limitations period contained in Section 2462 is inapplicable. This final effort to avoid statutory time constraints also may be doomed, however. *SEC v. Graham*,[2] a recent decision from the Southern District of Florida, if upheld, would require the SEC to timely investigate and file all enforcement actions regardless of the remedy sought.

Triggering Application

Enforcement actions brought by the SEC may seek a variety of remedies including civil money penalties and "equitable" remedies such as injunctions, disgorgement, and employment bars and suspensions. Section 2462 explicitly applies to actions "for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." The SEC has taken the position that equitable remedies do not qualify as penalties under the statute and therefore are not subject to its five-year limitations period.

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In April 2012, the U.S. Court of Appeals for the Fifth Circuit considered the agency's position in *SEC v. Bartek*.[3] In that action, the SEC sued the issuer and two of its officers for options backdating more than five years after the alleged scheme occurred. It sought an injunction and officer-and-director bars for the individuals, arguing that the statute of limitations set forth in Section 2462 is limited to a sanction that involves the collecting of money or property. The Fifth Circuit rejected the SEC's narrow definition, finding that the term "penalty" encompassed a variety of "punishments imposed by statute as a consequence of the commission of an offense."[4]

The court noted that even remedial sanctions like those sought by the SEC carry the sting of punishment, and a determination of whether the remedies sought are "penalties" subject to Section 2462 requires objective consideration by the court of "the degree and extent of the consequences to the subject of the sanction." This analysis, known as the Johnson test articulated by the U.S. Court of Appeals for the D.C. Circuit in *Johnson v. SEC*,[5] was employed by the district court in *Bartek*, which concluded that the collateral consequences that would result from the officer-director bars and injunctions were punitive, not remedial, in nature.

In affirming the district court's decision, the Fifth Circuit noted the penalizing character of the sanctions sought by the SEC, as distinguished from remedial sanctions sought only to prevent future harm. The court explained: "[t]he SEC's sought-after remedies would have a stigmatizing effect and long-lasting repercussions. Neither remedy addresses past harm allegedly caused by the [d]efendants. Nor does either remedy address the prevention of future harm in light of the minimal likelihood of similar conduct in the future."[6] Accordingly, the case was dismissed because it was brought after the expiration of the five-year limitations period set forth in Section 2462.

The SEC sought review of the Fifth Circuit's decision by the Supreme Court. In its relatively short certiorari petition, the SEC asserted that remedies such as injunctions and disciplinary bars traditionally have been viewed as remedial. For instance, in *Hudson v. United States*, the Supreme Court examined whether banking debarment sanctions were "criminal" in nature for double jeopardy purposes, finding that although the sanctions were "intended to defer future wrongdoing," they ultimately were a civil remedy that "serve[s] to promote the stability of the banking industry" and were therefore remedial in nature.[7]

> The SEC has taken the position that equitable remedies do not qualify as penalties under 28 USC §2462 and therefore are not subject to its five-year limitations period.

In *Hecht Co. v. Bowles*, a 1944 decision, the Supreme Court wrote that "[t]he historic injunctive process was designed to deter, not to punish," when considering the validity of an injunction brought to restrain the defendant's violation of the Emergency Price Control Acts.[8] Based on these decisions, the SEC urged the court to consider the issue of whether Section 2462 had any application to enforcement actions seeking remedial sanctions.

The SEC urged the court to hold its petition for certiorari in *Bartek* pending the court's decision in *Gabelli v. SEC*.[9] After the court handed down its decision in *Gabelli*, which rejected the SEC's often-invoked position that the fraud discovery rule[10] should be grafted onto Section 2462 to extend the date upon which the five-year statute of limitations accrued, the SEC withdrew its petition.[11] The question raised in the SEC's withdrawn certiorari petition in *Bartek*—whether Section 2462 applies to SEC enforcement actions for equitable relief—is at the heart of *SEC v. Graham*.

'SEC v. Graham'

The SEC accused the defendants in *Graham* of defrauding over 1,400 investors to the tune of more than $300 million by soliciting investments in a real estate development business. The defendants allegedly promised investors lucrative returns on their investment in condominium projects across the nation where undervalued and decaying apartment complexes were to be transformed into luxury resort destinations. Initial returns supposedly were paid from funds obtained from subsequent investors, in Ponzi-like fashion, and, according to the SEC, the developers ultimately abandoned the project, leaving investors out in the cold.

The SEC investigated the case for at least seven years. On Jan. 30, 2013, the SEC filed a complaint alleging violations of the registration and anti-fraud provisions of the federal securities laws, seeking: i) declaratory relief that violations of the securities laws had occurred; ii) injunctive relief barring future violations of the securities laws; and iii) the repatriation and disgorgement of ill-gotten gains.

The defendants moved for summary judgment arguing that the statute of limitations expired in December 2012, five years after the final act taken by any defendant in connection with the alleged scheme.[12] The SEC countered that Section 2462 does not apply where the SEC seeks equitable remedies such as disgorgement, and injunctive and declaratory relief.

In beginning his analysis, Southern District of Florida Judge James Lawrence King opined that Section 2462 was a jurisdictional limitations statute, finding that the statute's clear statement that a suit "shall not be entertained unless commenced within five years" served as a "congressional removal of a court's power to entertain—its adjudicatory authority and jurisdiction—cases not brought within five years of accrual."[13]

Judge King noted that in *Gabelli* the Supreme Court had fixed the accrual date of claims bound by Section 2462 as the date on which the last act giving rise to the cause of action occurred. Accordingly, in the context of the facts of the case, the court wrote, "where the last act of each defendant giving rise to the SEC's claim against such defendant was not committed within five years prior to the SEC's filing of its complaint—a window of time the Court and parties have referred to as the 'red zone'—if §2462 applies to the SEC's claims, it operates to divest the Court of the power to entertain that claim."[14]

The court then turned to the question of whether Section 2462 applied to the equitable claims brought by the SEC. Judge King characterized the actions within the scope of Section 2462 as "penalty" actions, noting that the Supreme Court's decision in *Gabelli* that the fraud discovery rule did not apply to Section 2462 "invoked Chief Justice Marshall's 'particularly forceful language…emphasizing the importance of time limits on penalty actions' that 'it would be utterly repugnant to the genius of our laws if actions for penalties could be brought at any distance of time.'"[15]

The court in 'Graham' held that the five-year statute of limitations set forth in Section 2462 applied to the equitable relief sought by the SEC. "To hold otherwise would be to open the door to Government plaintiffs' ingenuity in creating new terms for the precise forms of relief expressly covered by the statute in order to avoid its application."

The court concluded that penalties, pecuniary or otherwise, were the crux of the relief sought by the SEC in the instant case. The declaratory relief sought would label the defendants as wrongdoers. The injunctive relief sought would have the effect of forever barring the defendants from future violations of the securities laws, which the court believed should be regarded "as nothing short of a penalty 'intended to punish,' especially where, as here, no evidence (or allegations) of any continuing harm or wrongdoing has been presented." The disgorgement remedy requiring defendants to relinquish money and property, the court reasoned, is the equivalent of forfeiture, which is expressly covered by Section 2462.

Accordingly, the court held that the five-year statute of limitations set forth in Section 2462 applied to the equitable relief sought by the SEC. "To hold otherwise would be to open the door to Government plaintiffs' ingenuity in creating new terms for the precise forms of relief expressly covered by the statute in order to avoid its application."[16]

Although a motion for summary judgment was pending before the court, Judge King's sua sponte consideration of and conclusion that Section 2462 was a jurisdictional statute of limitations shifted the burden from the defendants to the SEC to establish jurisdiction. Because the agency was unable to identify any act of offering or sale of alleged securities by any of the defendants in the "red zone" of five years prior to the SEC's filing, the court dismissed the case with prejudice, ruling it had no subject matter jurisdiction over the action.

Conclusion

The SEC has appealed the decision in *Graham* to the U.S. Court of Appeals for the Eleventh Circuit. The Eleventh Circuit's decision will be highly anticipated. It likely will address not only the open question of Section 2462's application to equitable remedies, but also Judge King's jurisdictional view of Section 2462. In *Gabelli*, the Supreme Court recognized that the SEC has an obligation to investigate and prosecute in a timely manner. *Graham* and the Fifth Circuit's decision in *Bartek* underscore that obligation. These decisions, if sustained, will be the death knell for SEC's efforts to maintain an exception to that duty when it seeks only remedies deemed "equitable."

1. *Gabelli v. SEC*, 133 S.Ct. 1216 (2013).
2. 2014 WL 1891418 (S.D.Fla. May 12, 2014). See Robert Anello, "Supreme Court in Gabelli: Clock Starts Ticking When Fraud Occurs, Not When It's Discovered," Forbes.com (Feb. 27, 2013); Robert G. Morvillo and Robert J. Anello, "Statute of Limitations in SEC Enforcement Actions," NYLJ (April 5, 2011).
3. 484 Fed.Appx. 949 (5th Cir. 2012).
4. Id. at 956-57.
5. 87 F.3d 484, 487 (D.C.Cir. 1996).
6. 484 Fed.Appx. at 957.
7. 522 U.S. 93, 105 (1997).
8. 321 U.S. 321, 329 (1944).
9. Petition for a Writ of Certiorari, *SEC v. Bartek*, 12-1000, 2013 WL 543280 (Feb. 13, 2013).
10. The fraud discovery rule was created to ensure that victims of fraud who do not know they are injured are still able to bring their claims after they have discovered, or reasonably should have discovered, their injury.
11. *SEC v. Bartek*, 133 S.Ct. 1658 (Mem)(2013). Interestingly, in *Gabelli*, the court noted without comment that the lower court had found that the injunction and disgorgement sought were not subject to Section 2462. 133 S.Ct. at 1220 n.1.
12. The defendants also maintained that the securities laws were not implicated because the transactions at issue were simple real estate transactions. The court declined to rule on this issue, ruling only on the statute of limitations issue. 2014 WL 1891418 at *1 n.3.
13. 2014 WL 1891418 at *7.
14. Id.
15. 133 S.Ct. at 1223 (quoting *Adams v. Woods*, 2 Cranch 336, 342 (1805)).
16. 2014 WL 1891418 at *9.