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WHITE-COLLAR CRIME

Expert Analysis

Statute of Limitations In SEC Enforcement Actions

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In the face of criticism for its failure to uncover and end certain recently publicized, notorious conduct, the Securities and Exchange Commission has been flexing its muscles aggressively—sometimes in a manner that raises questions about whether the legislation that empowers it stretches as far as the agency believes. For example, although the Dodd-Frank Act expands the SEC's ability to seek administrative penalties against non-regulated persons, a recent lawsuit by Rajat Gupta, a former Goldman Sachs director alleged by the SEC to have provided inside information to Raj Rajaratnam, the Galleon Group founder currently on trial in the Southern District of New York, questions whether the administrative proceeding initiated by the agency against Mr. Gupta improperly applies the Dodd-Frank Act retroactively and deprives him of his right to a jury trial and other procedural safeguards offered in federal court.[1] This action raises a host of contested issues about the SEC's expanded power that will be addressed in the coming months.

A more often debated—yet still murky—topic is the nature of the statute of limitations that applies to SEC enforcement actions in cases alleging fraud. Starting in the mid-1990s, federal courts have ruled that the five-year limitation set forth in 28 U.S.C. §2462 applies to penalty claims by the SEC. Since then, an unhappy SEC has attempted to find ways to expand that limitation.

In recent years, the SEC has sought to graft on to the five-year limitation a common law doctrine known as the "discovery rule" to enable it to bring such actions within five years of the SEC's discovery of a fraud regardless of when the allegedly improper activity occurred and irrespective of whether the defendant engaged in efforts to conceal the conduct after its commission. To date, this position—which would give the SEC's enforcement division powers to penalize which would make federal prosecutors envious—has not met with much success. Adoption of the SEC's position could have far-reaching consequences for attorneys involved in representing securities professionals.

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The Statute of Limitations

Section 2462 is a general statute of limitations applicable to all civil penalty cases brought by the federal government. It provides that "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise" must be commenced within five years from the date of the claim's accrual. In *SEC v. Johnson*, the U.S. Court of Appeals for the D.C. Circuit held that an SEC proceeding against a securities industry supervisor was a "proceeding" within the meaning of §2462 and therefore subject to its five-year limitation.[2] Following the holding in *Johnson*, federal courts have applied section 2462 to relief sought by the SEC that seeks to punish, but the statute has been held not to apply to equitable relief which seeks to remedy a past wrong or protect the public from future harm.[3]

The relief sought by the SEC qualifies as a "penalty" where it "is a form of punishment imposed by the government for unlawful or proscribed conduct, which goes beyond remedying the damage caused to the harmed parties by the defendant's action." This determination is an objective measure of "the degree and extent of the consequences" of the sanction; the subjective perspective of the defendant is not relevant.[4]

Accrual of a Claim

Under section 2462, the five-year limitation begins to run when the claim accrues.

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Courts agree that the running of section 2462 can be tolled pursuant to principles of equitable tolling.[5] To prove equitable tolling or fraudulent concealment, a plaintiff such as the SEC must demonstrate: 1) that the defendants concealed the cause of action, either through some affirmative steps to prevent discovery of the fraud or that the wrong itself was self-concealing; 2) that the plaintiff did not discover the cause of action until some point within five years of commencing the action; and 3) that the plaintiff's ignorance was not attributable to a lack of diligence on its part.[6] This is different from the discovery rule, which historically has been applied in the context of common law fraud where the wrongdoing is inherently unknowable and does not require a plaintiff to show deliberate concealment by the defendant or diligence by the plaintiff.

In several recent cases where the SEC instituted proceedings more than five years after the challenged acts, the SEC has argued the application of the discovery rule to delay the accrual of a claim until the violation at issue is discovered. This approach has been rejected when raised by other federal agencies. In *3M Co. v. Browner*,[7] the D.C. Circuit Court considered the application of the discovery rule to section 2462 in a claim for penalties brought by the Environmental Protection Agency. Noting the general applicability of section 2462, the court rejected the notion that a particular agency's difficulties in discovering violations should be considered, especially because such difficulties did not offset concerns that arise when penalty actions are brought years after alleged violations occur.

Statutes of limitation exist to avoid problems of fairness such as lost evidence, faded memories and missing witnesses that arise after a significant passage of time. In addition, they "reflect the judgment that there comes a time when the potential defendant 'ought to be secure in his reasonable expectation that the slate has been wiped clean of ancient obligations.'"[8] For all these reasons, the court in *3M Co.* interpreted the phrase "claim accrued" as contained in section 2462 to mean the time at which a cause of action first existed or the violation occurred, not the time when the violation was first discovered.[9]

Unhappy, since the *Johnson* decision, with the application of any time limitation on its enforcement actions, the SEC argues that the holding in *3M Co.* is limited and does not apply in fraud cases. For the most part, federal courts have rejected the SEC's assertion. Most recently, in February 2011, in *SEC v. Microtune Inc.*,[10] U.S. District Judge Jane J. Boyle sitting in the Northern District of Texas summarily rejected the applicability of the discovery rule to the SEC's enforcement action for penalties resulting from an allegedly fraudulent stock-option backdating scheme.

The SEC's position is now at issue in a case pending in the U.S. Court of Appeals for the Second Circuit. In *SEC v. Gabelli*,[11] the defendants moved to dismiss the SEC's suit alleging securities fraud in connection with "market-timing" activities at a hedge fund with which the defendants were affiliated arguing, in part, that the five-year statute of limitations had run. Southern District of New York Judge Deborah A. Batts cited the D.C. Circuit's decision in *3M Co.* in holding the common law discovery rule to be inapplicable to section 2462. The SEC has appealed the ruling.

> The question arises—if the SEC has ample reports of suspicious conduct (a la Bernard Madoff), but delays in its response, would it still have the benefit of the five-year statute because it did not 'discover' the wrongdoing?

Other courts have declined specifically to decide the issue. In *SEC v. Alexander*,[12] Eastern District of New York Judge Nicholas Garaufis did not reach the question of when fraud claims subject to section 2462 accrue, but stated that "there are significant reasons for finding that a discovery rule governs the accrual of the limitations period contained in [the statute]." Judge Garaufis gave credence to the SEC's argument that most of the cases rejecting the application of the discovery rule to section 2462 were inapplicable because they did not involve fraud claims. Judge Garaufis noted that in rejecting the discovery rule's application to section 2462 in the non-fraud context, courts have relied on Supreme Court case law in existence at the time the predecessor statute to section 2462 was passed that made clear that, in general, claims accrued at the time the conduct giving rise to the claim occurred.[13]

The SEC argues that the law regarding the accrual of fraud claims was not as clear. Relying primarily on the Supreme Court's 1874 decision in *Bailey v. Glover*,[14] in which the Court held that a fraud claim brought under a bankruptcy statute did not begin to accrue until the claim was discovered or should have been discovered through due diligence, the SEC asserts that fraud claims generally have been held to accrue pursuant to a discovery rule.

The U.S. Court of Appeals for the Seventh Circuit also declined to directly decide whether the discovery rule applies to section 2462 in fraud cases brought by the SEC in *SEC v. Koenig*.[15] In *Koenig*, the defendant argued that the SEC's demand for civil penalties was untimely because the violations occurred more than five years before the SEC commenced the action. The district court disagreed, concluding that federal statute of limitations do not begin to run until the claim had been discovered.

On appeal, the Seventh Circuit found that it need not decide when a claim accrues for the purposes of section 2462 generally because, according to the panel, a special rule exists for fraud or a concealed wrong.

Conflating the discovery rule with traditional, but different notions of "equitable tolling," the Court stated that a fraud victim has until the date that the wrong came to light to bring an action and that the United States should enjoy the same benefit when suing to enforce laws that protect its citizens. "Whether a court says that a claim for fraud accrues only on its discovery (more precisely, when it *could have been* discovered by a person exercising reasonable diligence) or instead says the claim accrues with the wrong, but that the statute of limitations is tolled until the fraud's discovery, is unimportant in practice."[16]

The Seventh Circuit's failure to distinguish between the discovery rule and equitable tolling overlooks the considerable difference in proving each. An otherwise untimely cause of action can proceed under the doctrine of fraudulent concealment only where a defendant affirmatively conceals an action from a diligent plaintiff where the same action would be able to proceed under the discovery rule where a plaintiff (diligent or not) fails to discover the existence of the claim, without more.

Application of the discovery rule in SEC enforcement actions eliminates any consideration of the agency's "reasonable diligence." The question arises—if the SEC has ample reports of suspicious conduct (a la Bernard Madoff), but delays in its response, would it still have the benefit of the five-year statute because it did not "discover" the wrongdoing? No evidence exists that Congress, which has charged the SEC with promptly ferreting out misconduct, intended to allow the agency an unlimited time in which to institute proceedings if it fails in its surveillance function.

The Second Circuit will have to grapple with the issues raised in *Koenig* and *Alexander* in deciding the *Gabelli* appeal. The defendants in *Gabelli* distinguish *Bailey*, in which the "defendants kept secret and concealed from the parties interested the fraud which is sought to be redressed" from the facts of their case, noting that "[a]lthough it had the benefit of a multi-year investigation, the SEC has not alleged that Mr. Gabelli concealed any material facts from the SEC or any other party."[17]

As noted by the *Gabelli* defendants in their briefs to the Second Circuit, because of the broad application of section 2462, reading the discovery rule into the plain language of the statute allows the government a "virtually unlimited period of time to commence a punitive claim" and contravenes legislative intent. "When Congress has desired to include discovery provisions in federal statutes of limitations, it has no difficultly doing so expressly."[18] It did not do so in section 2462.

Practical Effect

The discovery rule rests on the idea that in cases involving latent injuries or injuries difficult to detect, plaintiffs cannot have a tenable claim for the recovery of damages until they discover the injury.[19] Although application of such a rule makes sense in the context of civil claims brought by private litigants, its role in punitive enforcement actions brought by a government agency charged with policing (i.e., discovering) the misconduct it is empowered to redress—essentially giving it an excuse for lax surveillance—seems inadvisable.

Put into context, the only federal crimes for which no time limitation exists are capital offenses for which the death penalty may be sought, acts of terrorism resulting in death or serious injury, and various designated federal child abduction and sex offenses.[20] Civil penalties sought by the government for alleged fraud are not in the same category as the penalties sought for these types of crimes borders. Indeed, the practical effect of the SEC's position would be the abolition of a statute of limitations replaced only by what essentially is a five-year speedy trial act. No indication exists that Congress ever intended such a situation.

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1. Complaint for Declaratory and Injunctive Relief and Demand for Jury Trial, *Gupta v. SEC*, 11cv1900 (S.D.N.Y. March 18, 2011).
2. *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996).
3. *SEC v. Jones*, 476 F. Supp.2d 374, 380-81 (S.D.N.Y. 2007).
4. *Johnson*, 87 F.3d at 488.
5. *Microtune*, 2011 WL 540280, at 4 ("parties do not dispute that the doctrine of fraudulent concealment, if established, would toll the running of Section 2462[]"); *Gabelli*, 2010WL 1253603, at 6-7 (fraudulent concealment did not toll running of the statute; plaintiff failed to plead with particularity acts taken by defendant to conceal wrongdoing); *SEC v. Alexander*, 248 F.R.D. 108, 120 (E.D.N.Y. 2007) (no dispute that statute of limitations is equitably tolled where elements of equitable tolling established).
6. 2010 WL 1253603, at 6-7.
7. 17 F.3d 1453 (D.C. Cir. 1994); rehearing and suggestion for rehearing en banc denied, (May 9, 1994).
8. Id. at 1457 (citing Note, "Developments in the Law—Statutes of Limitations," 63 Harv. L. Rev. 1177, 11185 (1950)).
9. Id. 1462.
10. 2011 WL 540280, at 4 n.7.
11. 2010 WL 1253603, at 5.
12. 248 F.R.D. at 120. The authors' firm represented the defendant in this action.
13. 17 F.3d at 1462.
14. 88 U.S. 342 (1874).
15. 557 F.3d 736 (7th Cir. 2009).
16. Id. at 739-40 (emphasis in original).
17. Brief of Marc J. Gabelli, Appellee-Cross-Appellant, *SEC v. Gabelli* ("*Gabelli* Brief"), 10-3581-cv at p. 40.
18. Gabelli Brief at pp. 35-36 (citing 28 U.S.C. §1658, private actions under Section 10(b) of the 1934 Act must be brought within two years of discovery (or at the latest five years of the events giving rise to the claim); 15 U.S.C. §77m (permitting certain claims under the 1933 Act to be brought within one year of discovery (or at the latest three years)). See also Brief of Bruce Alpert, Defendant-Appellee/Cross-Appellant, *SEC v. Gabelli,* 10-3581-cv at p. 17 n.8 (citing limitations provisions containing express discovery rules).
19. 17 F.3d at 1460.
20. CRS Report for Congress, "Statutes of Limitation in Federal Criminal Cases: An Overview" at pp. 2-3 (updated April 9, 2007).

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