Government Enforcement Actions

Supreme Court Holds “Discovery Rule” Does Not Apply to General Federal Statute of Limitations for Government Enforcement Actions Seeking Civil Penalties

SUMMARY

On February 27, 2013, the U.S. Supreme Court unanimously held that the five-year statute of limitations for Securities and Exchange Commission enforcement actions seeking civil penalties under the Investment Advisors Act is not subject to the “discovery rule” exception for fraud claims, which delays the running of the limitations period until a plaintiff discovers the alleged fraudulent activity. *Gabelli v. SEC*, 568 U.S. ___ (2013). Rather, the Court held that the five-year limitations period begins to run in fraud cases when the allegedly fraudulent conduct occurs. This decision has implications for many federal enforcement activities, because the relevant statute of limitations, 28 U.S.C. § 2462, applies to many civil penalty provisions in federal statutes, including outside the securities laws.

BACKGROUND

In 2008, the SEC brought an enforcement action seeking civil penalties against defendants Marc Gabelli and Bruce Alpert. The SEC alleged that from 1999 until 2002, defendants allowed an investor to engage in market timing in a mutual fund managed by defendants without disclosing the market timing arrangement to other investors. At the same time, defendants banned other investors from engaging in market timing in the same fund and made statements to investors that the practice would not be tolerated. The SEC alleged that defendants’ actions aided and abetted violations of anti-fraud provisions of the Investment Advisors Act and sought civil penalties and other remedies.

Defendants moved to dismiss, in part, on grounds that the cause of action for civil penalties was untimely. The applicable statute of limitations provides that “[e]xcept as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture . . . shall not be
entertained unless commenced within five years from the date when the claim first accrued . . . .” 28 U.S.C. § 2462. Defendants argued that a claim based on fraud accrues—and the limitations period begins to run—when a defendant’s allegedly fraudulent conduct occurs. Because the allegedly fraudulent conduct stopped in 2002, defendants argued that the SEC’s 2008 action was time-barred.

The SEC argued that the discovery rule should apply, under which accrual of a cause of action for fraud, and, therefore, the running of the statute of limitations, is delayed until plaintiff has discovered the fraud. The District Court dismissed the SEC’s civil penalty claim as time-barred, but the Second Circuit reversed, accepting the SEC’s argument that the discovery rule applies to the statute of limitations in claims that sound in fraud, including in government enforcement actions.

THE SUPREME COURT’S DECISION

The Supreme Court unanimously reversed the Second Circuit, holding that a cause of action for civil penalties based on fraud accrues under § 2462 when the allegedly fraudulent conduct occurs. The Court explained that “[t]his reading sets a fixed date when exposure to the specified Government enforcement efforts ends, advancing ‘the basic policies of all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff’s opportunity for recovery and a defendant’s potential liabilities.’” Gabelli, 568 U.S. ___ (citing Rotella v. Wood, 528 U.S. 549, 555 (2000)).

In declining to apply the discovery rule, the Supreme Court drew a distinction between victims of fraud and government regulators, stressing that the Court had never applied the discovery rule “where the plaintiff is not a defrauded victim seeking recompense, but is instead the Government bringing an enforcement action for civil penalties.” The Court explained that the reason for the development of the discovery rule—that private parties “do not typically spend [their] days looking for evidence that [they] were lied to or defrauded” absent any reason to think that they have been injured—does not apply to the SEC, which has a “central mission . . . to investigate potential violations of the federal securities laws.” The Court also compared the SEC’s enforcement tools, such as subpoena power and cooperation agreements, to further contrast the SEC’s role as an enforcer “from the defrauded victim the discovery rule evolved to protect.”

Finally, the Court reasoned that if the discovery rule applied to government enforcement actions, “[r]epose would hinge on speculation about what the Government knew, when it knew it, and when it should have known it.” The Court emphasized the practical difficulties involved in determining the government’s knowledge, potentially across many offices around the country.
IMPLICATIONS

The five-year limitations period of § 2462 broadly covers federal government enforcement actions seeking a civil penalty.\(^1\) As a result, the *Gabelli* holding applies to all government enforcement actions covered by § 2462.

The practical effect of this decision may be limited. In many, if not most, cases, government regulators learn of misconduct before the five-year limitations period has run. Oftentimes, the alleged misconduct will continue to a period within the limitations period, even if it started many years ago. That said, this decision will limit the ability of federal regulators to seek a civil penalty in some cases. The Court's decision also provides a roadmap for potential challenges to the application of the discovery rule under other federal statutes of limitations applicable to federal enforcement actions seeking punitive relief.

Because the *Gabelli* decision was unanimous, and because of the current divided political situation in Washington, the SEC likely would face an uphill battle in trying to “reverse” this decision through congressional amendment to § 2462.

\(^1\) Certain exceptions to the applicability of § 2462 exist. For example, the limitations period in § 2462 does not apply to the assessment of certain penalties by the IRS. *See Capozzi v. United States*, 980 F.2d 872 (2d Cir. 1992).
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