

Supreme Court Rejects Discovery Rule on Statute of Limitations for Government Enforcement Actions Seeking Civil Penalties

By Timothy P. Crudo and Eric Chen

In February, the Supreme Court in *Gabelli v. Securities and Exchange Commission* rejected the application of the “discovery rule” in government enforcement actions seeking civil penalties. The Court declined to hold that the five-year statute of limitations governed by 28 U.S.C. § 2462 begins to run only when the government discovers or reasonably could have discovered the fraud. Instead, Chief Justice Roberts, writing for a unanimous Court, held that the five-year clock begins to run when the fraud occurs, regardless of when it was discovered or reasonably could have been discovered. While this decision has immediate and obvious implications for current SEC cases that rely on the discovery rule and for those in the agency’s investigation pipeline that might now be stale, it also may have a broader impact beyond the discovery rule and SEC enforcement actions.

Background

In April 2008, the SEC brought a civil enforcement action against a mutual fund portfolio manager and the COO of the fund’s investment adviser. The SEC alleged that, from 1999 to 2002, the defendants had allowed a mutual fund investor to engage in “market-timing.” Market-timing is a form of short-term trading that allows the investor to exploit time delays in a mutual fund’s daily valuation system. While not illegal, the SEC has taken the position that the practice may harm long-term fund investors. The SEC alleged that the defendants allowed the investor to engage in market-timing in exchange for the investor’s participation in another hedge fund that they managed. While

banning other investors from engaging in market-timing and stating that it did not permit the practice, the mutual fund did not disclose the alleged market-timing or the quid pro quo arrangement. During this alleged scheme, the investor earned significantly greater returns in the fund than did long-term investors, who realized negative returns.¹

The SEC sued the defendants in the Southern District of New York for fraud in violation of the Investment Advisers Act of 1940 (IAA).² The defendants argued that the SEC’s request for civil penalties under the IAA was time-barred, invoking the five-year statute of limitations allowed for civil penalties under 28 U.S.C. § 2462. Section 2462 states that “an action ... 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.” The defendants pointed out that the SEC’s complaint alleged that the illegal activity occurred until August 2002, but the complaint was not filed until April 2008. The SEC, in turn, relied upon the discovery rule, which provides that a cause of action accrues only when the violation was discovered or should have been discovered, not when the violation occurred. The district court agreed with the defendants and dismissed the SEC’s civil penalty claims as time-barred.

On appeal, the Second Circuit reversed. While the appellate court acknowledged that § 2462 required that an action for civil penalties be brought within five years “from the date when the claim first accrued,” it accepted the SEC’s argument that, because the underlying violations sounded in fraud, the discovery rule applied and the penalty claim did not accrue until September 2003, when the SEC discovered the fraud. The Second Circuit explained that, “[u]nder the

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discovery rule, the statute of limitations for a particular claim does not accrue until that claim is discovered, or could have been discovered with reasonable diligence, by the plaintiff.”³

The Supreme Court’s Decision

In a unanimous opinion, the Supreme Court observed that it has never applied the discovery rule to claims in which the plaintiff is the government seeking to bring an enforcement action for civil penalties. Rather, the Court noted that the discovery rule was developed to aid defrauded victims seeking recompense. The Court provided several reasons for rejecting the discovery rule in government enforcement actions subject to § 2462.

First, the Court noted that the most natural reading of the statute establishes a fixed date by which exposure to government enforcement actions ends, thus advancing the basic policy goals of “repose, elimination of stale claims, and certainty about a plaintiff’s opportunity for recovery and a defendant’s potential liabilities.”⁴

Second, the Court observed that the discovery rule was developed in cases of fraud to protect private party victims who are unaware that they had been harmed. On the other hand, the “SEC’s very purpose is to root out [fraud], and it has many legal tools at hand to aid in that pursuit.”⁵ Those tools include the ability to subpoena documents and witnesses, pay monetary awards to whistleblowers, and offer cooperation agreements to violators to obtain information in exchange for more lenient treatment. Because of the SEC’s organizational mission and the resources available to it, the Court noted that “the SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect.”⁶

Third, the Court noted that, not only was the SEC a different type of plaintiff, but it also sought a different type of relief than that generally available in matters subject to the discovery rule. While the discovery rule was meant to help

recompense injured parties, the SEC was seeking not to compensate victims but to obtain civil penalties, which were intended to punish the defendants as wrongdoers.

Finally, the Court emphasized the uncertainty of determining when the § 2462 clock begins to run if a discovery rule applied to government enforcement actions. “Repose would hinge on speculation about what the Government knew, when it knew it, and when it should have known it.”⁷ The Court noted the difficulties of determining when a government agency, which may include “hundreds of employees, dozens of offices, and several levels of leadership,” as opposed to an individual, knew or reasonably should have known of an alleged fraud. In addition, the Court noted that federal agencies often assert an array of privileges in order to block the discovery needed to help determine when the government knew or should have known of an alleged fraud.

Gabelli’s Impact

Some of *Gabelli’s* ramifications are readily apparent. The SEC will need to move more swiftly in identifying and charging cases in which it seeks civil penalties. More immediately, the decision may spur a wave of filings as the agency rushes to bring cases related to the 2008 financial crisis within the five-year deadline. A brighter line has been drawn as to when a claim accrues, which may provide more opportunities for defendants in future matters to dispose of cases on an early motion to dismiss. Cases now pending that relied on the discovery rule may also be ripe for dismissal. But *Gabelli’s* impact may prove to be even broader.

Beyond Securities Fraud

While *Gabelli* involved a claim for securities fraud under the IAA, § 2462, the statute scrutinized by the Supreme Court, makes no mention of fraud, the IAA, or even the SEC. The five-year limitations period of that statute applies broadly to any “action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise.”⁸ Thus

Gabelli's holding applies to any claim, whether or not sounding in fraud, brought by the SEC under any substantive statute, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, as well as the IAA.

More significantly, § 2462 also applies to claims brought by other government agencies beyond the SEC, including the Federal Trade Commission, the Social Security Administration, and the Environmental Protection Agency. As long as the “action, suit or proceeding” seeks to enforce any “civil fine, penalty, or forfeiture, pecuniary or otherwise,” it is governed by § 2462. Whether the rationale of *Gabelli* applies to actions brought by other agencies may hinge on the extent to which those agencies, like the SEC, have an enforcement-like purpose of “rooting out” the conduct at issue and have comparable resources, such as subpoenas and the ability to induce and reward cooperation, “to aid in that purpose.” The Supreme Court seemed to find the enforcement role significant in ruling that the SEC was not the type of plaintiff for which the discovery rule was intended.

Fraudulent Concealment

The Supreme Court expressly noted that its decision in *Gabelli* did not reach the fraudulent concealment doctrine or other equitable tolling principles that the SEC had not raised, which principles may have had a similar effect of extending the time for the SEC to file suit.⁹ These equitable doctrines, which toll the running of a statute of limitations, are different from the discovery rule, which governs when a claim accrues in the first place. The discovery rule focuses on the underlying, self-concealing fraudulent conduct and delays the date on which the statute of limitations clock begins to tick, while the fraudulent concealment doctrine is premised upon an act of fraud subsequent to the challenged conduct that conceals the underlying conduct and pauses a clock that has already started to tick.

While courts have unevenly applied the doctrine of equitable tolling based on fraudulent

concealment, most require, at the minimum, that the plaintiff demonstrate that (1) the defendant concealed the existence of the cause of action; and (2) the plaintiff failed, despite the exercise of due diligence on its part, to discover the facts that form the basis of his claim.¹⁰ Many courts also include another element, that (3) the plaintiff commenced the action within five years of discovering the cause of action.¹¹

Despite the differences between the discovery rule and equitable tolling, courts not infrequently either confuse or merge the analysis of the two, particularly where the charged conduct is itself fraud.¹² As the Seventh Circuit noted in *SEC v. Koenig*, “[w]hether 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 that the claim accrues with the wrong, but that the statute of limitations is tolled until the fraud’s discovery, is unimportant in practice. Either way, a victim of fraud has the full time from the date that the wrong came to light.”¹³

Post-*Gabelli*, the SEC may face a more difficult hurdle in arguing that the five-year limitations period of § 2462 should be equitably tolled due to fraudulent concealment. For one, the Supreme Court in *Gabelli* firmly rejected the SEC’s position that it should be treated as any other plaintiff, emphasizing that the “self-concealing” nature of conduct does not support delaying the accrual of a claim brought by the SEC, whose “very purpose is to root out [fraud],” whose central mission” is to investigate violations of the federal securities laws, and who is equipped with a number of “legal tools at hand to aid in that pursuit.” In fact, counsel for the SEC stated at oral argument that, if the Court refused to extend the discovery rule to the SEC in fraud cases, the same arguments could be leveraged to dismiss the SEC’s use of the fraudulent concealment doctrine as well.¹⁴ Moreover, the Court’s concern as to the difficulties in determining “what the Government knew, when it knew it, and when it should have known it” for purposes of the discovery rule apply equally to an analysis under equitable

tolling. The Court's broad language in *Gabelli* extolling the virtues of repose may further disincline courts to accept the SEC's use of the fraudulent concealment doctrine. The egregiousness of the defendant's conduct that purports to give rise to equitable tolling could be a particularly significant factor in courts' future application of those principles.

Equitable Relief

As for § 2462's application to equitable remedies such as disgorgement that seek to remedy a past wrong, some courts have agreed with the SEC that that provision does not apply to claims seeking such remedies because they are not actions for a "penalty" within the meaning of the statute.¹⁵ In fact, the district court in *Gabelli* found the SEC's disgorgement claim timely, since it was not subject to § 2462 and that decision was not reviewed by the Supreme Court. Similarly, courts have held that § 2462 does not apply to equitable claims for injunctions that seek solely to restore the status quo before the alleged violations or to protect the public from future harm.¹⁶

In some circumstances, courts have applied § 2462 to actions for equitable relief that arguably seek to punish the defendant.¹⁷ In *SEC v. Bartek*, the Fifth Circuit considered whether permanent SEC injunctions, including officer and director bars, were subject to the same statute of limitations as actions for penalties. In an unpublished opinion, the Fifth Circuit held that the SEC's claims for equitable relief were effectively penal rather than remedial due to their "severity and permanent nature."¹⁸ The Fifth Circuit affirmed the district court's ruling that such injunctive relief and officer and director bars constituted penalties as a matter of law because "(1) these remedies would have significant collateral consequences to the Defendants; (2) they do not address the past harm caused by the Defendants; and (3) the remedies do not focus on preventing harm due to the low likelihood that the Defendants would engage in similar harmful behavior in the future."¹⁹ As a result, the Fifth Circuit held that SEC actions seeking these injunctions, as penalties, were subject to

the § 2462 limitations period. Those actions are now subject to *Gabelli*. Should other courts follow the Fifth Circuit's lead in determining that certain equitable relief is actually punitive and subject to § 2462 and, therefore, *Gabelli*, the SEC could find itself further constrained.

Conclusion

The broader ramifications of *Gabelli* will have to play out in the lower courts before the true reach of the Supreme Court's decision is known. In the meantime, defendants will have greater certainty on their exposure for older conduct in SEC enforcement actions seeking penal remedies, while at the same time the SEC will need to move more quickly or risk losing enforcement opportunities.

Notes

1. *Gabelli v. SEC*, slip op. at 3, 568 U.S. ___ (2013).
2. *SEC v. Gabelli*, No. 08-civ-3868, 2010 WL 1253603 (S.D.N.Y. Mar. 17, 2010).
3. *SEC v. Gabelli*, 653 F.3d 49, 59 (2d Cir. 2011).
4. *Gabelli*, *supra* note 1, slip op. at 5.
5. *Id.*, *supra* note 1, slip op. at 8.
6. *Id.*
7. *Id.* (citing *Rotella v. Wood*, 528 U.S. 549, 554 (2000)).
8. 28 U.S.C. § 2462.
9. *Gabelli*, *supra* note 1, slip op. at 4, n.2.
10. *See SEC v. Microtune, Inc.*, 783 F. Supp. 2d 867, 875 (N.D. Tex. 2011).
11. *See SEC v. Wyly*, 788 F. Supp. 2d 92, 104 (S.D.N.Y. 2011).
12. *See SEC v. Koenig*, 557 F.3d 736, 739-40 (7th Cir. 2009) (holding that claim for penalties was timely on application of either discovery rule or fraudulent concealment doctrine because SEC did not have notice of the need for inquiry until a press release brought to public attention the defendant's misleading accounting practices); *see also, e.g., Pearl v. City of Long Beach*, 296 F.3d 76, 80 (2d Cir. 2002); *SEC v. Microtune, Inc.*, 783 F. Supp. 2d at 874-75 (discussing confusion in the case authority regarding fraudulent concealment, the discovery rule and equitable tolling).
13. *SEC v. Koenig*, 557 F.3d at 739.

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14. Oral Argument at 45:17-47:35, *Gabelli v. SEC*, 568 U.S. ____ (2013), available at http://www.supremecourt.gov/oral_arguments/argument_transcripts/11-1274.pdf.
15. *See, e.g.*, *SEC v. McCaskey*, 56 F. Supp. 2d 323, 326 (S.D.N.Y. 1999); *SEC v. Williams*, 884 F. Supp. 28, 30 (D. Mass. 1995); *SEC v. Lorin*, 869 F. Supp. 1117, 1121-1123 (S.D.N.Y. 1994).
16. *See, e.g.*, *United States v. Telluride Co.*, 146 F.3d 1241, 1247-48 (10th Cir. 1998); *United States v. Banks*, 115 F.3d 916, 919 (11th Cir. 1997).
17. *See, e.g.*, *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996) (holding that § 2462 applied to SEC administrative proceeding that resulted in censure and six-month disciplinary suspension of securities broker because the sanctions constituted a “penalty” within § 2462); *SEC v. Jones*, 476 F. Supp. 2d 374, 385 (S.D.N.Y. 2007) (holding that § 2462 applied to permanent injunction prohibiting defendants from committing future violations of Advisers Act because its potential collateral consequences were so serious as to constitute a “penalty” and subject to the § 2462 limitations period).
18. *SEC v. Bartek*, 484 F. App’x 949, 957 (5th Cir. 2012), petition for cert. filed Feb. 13, 2013.
19. *Id.* at 956.