

# CLIENT UPDATE

## SUPREME COURT REJECTS APPLICATION OF THE DISCOVERY RULE TO PENALTY ACTIONS BROUGHT UNDER 28 U.S.C. 2462

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On February 27, 2013, the U.S. Supreme Court unanimously held that for civil penalty actions brought by the government, the five-year statute of limitations set forth in 28 U.S.C. § 2462 begins to run when the alleged fraud occurs and not, as the Securities and Exchange Commission (“SEC”) had argued, when the fraud is discovered. In *SEC v. Gabelli*, the Court refused to graft the discovery rule onto § 2462, noting the lack of any “textual, historical, or equitable reasons” to do so. The *Gabelli* decision is significant not only for providing much needed clarity on when a claim accrues for purposes of § 2462, but also because it impacts a wide array of government penalty actions well beyond the securities area.

*Gabelli* involved an enforcement action brought by the SEC against mutual fund executives who allegedly aided and abetted violations of the antifraud provisions of the Investment Advisers Act (“IAA”) by allowing a customer to market-time one of the funds under management. The alleged market timing took place between 1999 and August 7, 2002, with tolling agreements extending the statute of limitations by an additional seven months. The SEC, however, did not file a complaint until April 24, 2008, more than five years and seven months after the last conduct at issue. Defendants moved to dismiss the SEC’s penalty claims, arguing that any claim for penalties was time-barred by the five-year limitations period in § 2462. In

response, the SEC asserted that the discovery rule applied to claims sounding in fraud and, therefore, the claims did not accrue for purposes of the statute of limitations until the SEC knew or should have known of the alleged misconduct. The district court granted defendants' motion to dismiss, specifically rejecting the application of the discovery rule to § 2462. On appeal, the Second Circuit reversed, holding that "for claims that sound in fraud, a discovery rule is read into the relevant statute of limitations."

### THE SUPREME COURT'S ANALYSIS

Chief Justice Roberts, writing for a unanimous Court, first analyzed the text of § 2462, noting that the "most natural reading of the statute" supported the conclusion that a claim based on fraud accrues for purposes of a penalty action brought under § 2462 when the fraudulent conduct occurs and not upon discovery. This textual analysis, the Court held, allows for a fixed date when exposure to government enforcement action ends, thereby providing repose to defendants and the elimination of stale claims.

Turning to the historical application of the discovery rule, the Court observed that it had never applied the discovery rule in the context of a government enforcement action, a fact that was further underscored by the government's inability "despite the discovery rule's centuries-old roots" to cite a single lower court decision before 2008 where the discovery rule had been asserted in a government enforcement action for civil penalties. The Court distinguished instances where the government was asserting a claim as a victim seeking recompense for an injury, in which case the discovery rule could apply, from cases such as *Gabelli*, where the government was acting "as enforcer" and bringing an action for penalties. In the case of the SEC, for example, the Court observed that, unlike an individual victim of a fraud who relies on "apparent injury to learn of the wrong," the SEC's "central mission" is to "root [ ] out" fraud. The Court pointed to the fact that the SEC has many tools at its disposal to carry out this mission, including the authority to require investment advisers to provide books and records for inspection, the power to issue pre-lawsuit subpoenas for documents and testimony, and the ability to authorize substantial monetary awards to whistleblowers. The Court concluded that the government as enforcer seeking to punish a defendant is a "far cry" from the plaintiff who is the victim of a fraud and who needs the protection of the discovery rule.

Finally, the Court stressed the difference between an action seeking penalties and one seeking recompense for an injury, focusing particularly on the importance of repose for penalty actions. The Court held that reading the discovery rule into § 2462 would lead to uncertainty and speculation as to when the government knew or should have known

about an alleged claim, particularly when the government could be expected to assert any number of privileges to preclude production of relevant information.

### **POTENTIAL IMPLICATIONS OF THE DECISION**

The *Gabelli* decision should come as welcome news for those facing drawn out investigations by the SEC or other government agencies by clarifying that the discovery rule does not apply to § 2462 – an issue that had vexed the lower courts and defendants in SEC actions for several years. Although *Gabelli* closes the door on the discovery rule, we expect the SEC will turn more aggressively to other theories to preserve otherwise stale claims, including the doctrine of fraudulent concealment and the continuing violation doctrine, neither of which were before the Court or addressed by the Court in the *Gabelli* decision.

It remains to be seen, however, how the *Gabelli* decision will impact SEC actions going forward. The ability to seek monetary penalties is certainly an important consideration for the SEC when deciding whether to bring enforcement actions. As such, *Gabelli* may influence not only the speed with which cases are brought, but also the determination of whether to bring an enforcement action at all in those cases where claims for monetary penalties may be time-barred. In addition, we expect the SEC will seek to limit the impact of *Gabelli* by asserting that § 2462's five-year limitations period applies only to claims for monetary relief, and does not impact the SEC's ability to seek equitable relief, such as disgorgement, injunctions and director and officer bar orders. While the SEC is on relatively firm ground with respect to disgorgement, lower courts have come to differing conclusions on whether, under certain circumstances, injunctions and director and officer bars can constitute "penalties" subject to § 2462. Armed with a more defendant-friendly accrual date post-*Gabelli*, defendants will no doubt urge courts to interpret more broadly what constitutes a "penalty" subject to § 2462, thereby potentially foreclosing a wide swath of SEC available remedies.

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Please do not hesitate to contact us with any questions.

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