Recent Cases Consider Challenges to Constitutionality of SEC's Administrative Law Judges

Since the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") expanded the authority of the Securities and Exchange Commission ("SEC") to seek civil penalties through administrative proceedings,[1] the SEC has brought, as one court observed, "an ever increasing number of enforcement actions within its own administrative scheme, rather than in federal court."[2] In 2014, for instance, the SEC initiated 43% of its litigated actions as administrative proceedings.[3] This shift may be due, at least in part, to the reported advantage the SEC enjoys before its own Administrative Law Judges ("ALJs"). From October 2010 through March 2015, the SEC won 90% of its litigated administrative proceedings. By comparison, the SEC won only 69% of the cases it brought in district court over the same time period.[4]

In light of this discrepancy, a growing number of respondents in administrative proceedings have sought to require the SEC to litigate in district court. Suing the SEC in federal district court, they allege various constitutional deficiencies with the administrative law proceedings and request an injunction to stop them. One recent approach is for respondents to challenge the constitutionality of the ALJs under Article II of the Constitution. This year, five district court judges have considered such suits, with one agreeing that the SEC's administrative process likely is unconstitutional.[5]

I. Background

Article II of the Constitution defines the authority of the Executive branch and includes the Appointments Clause, which provides that "inferior Officers" may be appointed only by the President, the "Courts of Law," or the "Heads of Departments."[6] Respondents seeking to enjoin SEC administrative proceedings have argued that "since ALJs are not appointed by the SEC Commissioners themselves, *i.e.*, the head of a department, the ALJ appointments scheme is unconstitutional."[7] Further, because ALJs can be removed only for "good cause" by the SEC Commissioners, who themselves may not be removed "except for inefficiency, neglect of duty, or malfeasance in office," respondents have argued that the current system interferes with the President's constitutional power to remove officers.[8]

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[1] *See Bebo* v. *SEC*, No. 15-C-3, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015) (Dodd-Frank "made the SEC's authority in administrative penalty proceedings 'coextensive' with its authority to seek penalties in federal court").

[2] *Tilton* v. *SEC*, No. 1:15-cv-02472-RA, slip op. (S.D.N.Y. June 30, 2015) (hereinafter "*Tilton*, slip op.").

[3] Andrew Ceresney, Remarks to the American Bar Association's Business Law Section Fall Meeting, Nov. 21, 2014, *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#_ftnref11. So far this year, the SEC has brought 37% of its contested matters in federal court. Jean Eaglesham, *U.S. Chamber of Commerce Criticizes SEC's In-House Court*, WALL ST. J., July 15, 2015, *available at* http://www.wsj.com/articles/u-s-chamber-of-commerce-criticizes-secs-in-house-court-1436932861.

[4] Jean Eaglesham, *SEC Wins With In-House Judges*, WALL ST. J., May 6, 2015, *available at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[5] *See Tilton*, slip op.; *Spring Hill Capital Partners, LLC* v. *SEC*, No. 1:15-cv-04524-ER (S.D.N.Y. June 26, 2015), ECF No. 23 (unpublished order dismissing case) (hereinafter "*Spring Hill* order"); *Hill* v. *SEC*, No. 1:15-CV-1801-LMM (N.D. Ga. June 8, 2015), slip op. (hereinafter "*Hill*, slip op."); *Duka* v. *SEC*, No. 15-CV-0357 (RMB), 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015); *Bebo*, 2015 WL 905349.

[6] U.S. CONST. art. II, § 2, cl. 2.

[7] *Tilton*, slip op. at 4.

[8] *Id.* (internal quotation marks omitted).

When challenging the constitutionality of SEC administrative proceedings—whether under Article II or another constitutional provision—respondents face the initial hurdle of establishing that the district court has subject matter jurisdiction even to consider the suit. That is because, in the normal course, respondents are permitted by statute to challenge the proceeding in a federal court of appeals after it is complete and the Commission has issued a final order.[9] In *Free Enterprise Fund* v. *Public Company Accounting Oversight Board*,[10] the Supreme Court set forth the circumstances under which such statutory review schemes do not deprive federal district courts of jurisdiction. Under *Free Enterprise Fund*, a statutory review scheme does not preclude federal district courts from exercising jurisdiction "[1] if 'a finding of preclusion could foreclose all meaningful judicial review'; [2] if the suit is 'wholly collateral to a statute's review provisions'; and [3] if the claims are 'outside the agency's expertise.'"[11] Analyzing these three factors necessarily "involves case-specific determinations," so "[w]hether jurisdiction exists in a particular instance depends in significant part on the nature of the constitutional claim at issue."[12]

II. To Date, One of Two District Courts to Reach the Merits of an Article II Challenge to ALJs Has Found the SEC's Administrative Process Likely Unconstitutional

To date, five district courts have considered Article II challenges to the SEC's ALJs. Of those, one district court found the SEC's administrative process likely unconstitutional and agreed to enjoin an administrative proceeding;[13] three ruled they lacked subject matter jurisdiction and dismissed the suits;[14] and the fifth exercised jurisdiction but found no likelihood that the respondent would prevail on the merits and thus denied a motion for a preliminary injunction and temporary restraining order.[15]

Two of the district courts to rule that they lacked jurisdiction did so in published opinions: *Bebo* v. *SEC*, from the Eastern District of Wisconsin, and *Tilton* v. *SEC*, from the Southern District of New York.[16] The *Bebo* and *Tilton* courts analyzed the *Free Enterprise Fund* factors the same way. First, they agreed that meaningful judicial review is available because even "[i]f the [SEC] process is constitutionally defective, [the respondent] can obtain relief before the Commission, if not the court of appeals."[17] The courts rejected the respondent's argument that they should not have to endure the same proceedings they alleged are unconstitutional and shoulder the associated expenses. "Oftentimes in our system," *Tilton* observed, "a party challenging the legality of the very proceeding or forum in which she is litigating must 'endure' those proceedings before obtaining vindication."[18] To find otherwise would create "an exception to the enforceability of statutory review schemes" that "could swallow the schemes themselves."[19] Both courts held that the respondents' Article II arguments were not wholly

[9] *See id.* at 3 (citing 15 U.S.C. § 78y(a)).

[10] 561 U.S. 477 (2010).

[11] *Tilton*, slip op. at 3 (quoting *Free Enterprise Fund*, 561 U.S. at 489) (emphasis added and some internal quotation marks omitted).

[12] *Chau* v. *SEC*, No. 14-cv-1903 (LAK), 2014 WL 6984236, at *5 (S.D.N.Y. Dec. 11, 2014); *see Gupta* v. *SEC*, 796 F. Supp. 2d 503, 512-14 (S.D.N.Y. 2011) (exercising jurisdiction over equal protection and due process claims).

[13] *Hill*, slip op. at 43.

[14] *Tilton*, slip op. at 23; *Spring Hill* order at 1; *Bebo*, 2015 WL 905349, at *4.

[15] *Duka*, 2015 WL 1943245, at *10.

[16] The court in *Spring Hill Capital Partners, LLC* v. *SEC* rejected jurisdiction in an unpublished order.

[17] *Bebo*, 2015 WL 905349, at *3; *see also Tilton*, slip op. at 7 (finding "review in a circuit court of appeals" sufficient).

[18] *Tilton*, slip op. at 8-9.

[19] *Id.* at 8; *see also Bebo*, 2015 WL 905349, at *4 ("Bebo's argument . . . lies in her objection to being subject to a procedure that she contends is wholly unconstitutional. But . . . district court jurisdiction 'is not an escape hatch for litigants to

collateral to the administrative proceedings because the respondents had raised them before the SEC as affirmative defenses. This fact sufficiently "intertwined" the claims with the proceedings, although the *Tilton* court described the question as "close."[20] Finally, both courts acknowledged that constitutional arguments are not within the SEC's expertise, but found that fact not dispositive given the possibility of appeal to a federal circuit court, which has expertise in the issues.[21] The judges thus dismissed the cases, even though the *Bebo* court described the respondent's Article II argument as "compelling and meritorious."[22]

The other two cases to consider Article II challenges to SEC ALJs are *Duka* v. *Hill*, from the Southern District of New York, and *Hill* v. *SEC*, from the Northern District of Georgia. *Duka* and *Hill* agreed with *Bebo* and *Tilton* that the SEC does not have constitutional expertise,[23] but they took an opposing view of the first two *Free Enterprise Fund* factors. The *Duka* court reasoned that because the respondent's "claim for injunctive and declaratory relief would likely be moot" after the SEC issued a final order,[24] the court of appeals "would be unable to remedy . . . the substantial litigation and resource burdens incurred during [the] administrative proceeding."[25] The courts further deemed the challenges wholly collateral because they did not relate to the conduct of the particular proceedings at issue.[26] Accordingly, both courts exercised jurisdiction to consider the merits of respondents' constitutional arguments.

On the merits, the courts reached different conclusions on whether to enjoin the SEC administrative proceeding. The *Duka* court denied an injunction because it found that the respondent was not likely to succeed on her claim that ALJs' tenure protections violate Article II.[27] Because ALJs exercise adjudicatory functions, the court held, limiting the President's ability to remove them is necessary to protect their independence.[28] The *Hill*

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delay or derail an administrative action when statutory channels of review are entirely adequate.'" (quoting *Chau*, 2014 WL 6984236, at *6)).

[20] *Tilton*, slip op. at 19-20; *see also id.* at 16 ("[T]here is no indication that evidence relating to Plaintiffs' affirmative defense would not be included in the administrative record."); *Bebo*, 2015 WL 905349, at *4 (noting "the administrative record can include evidence relevant to an affirmative defense").

[21] *See Tilton*, slip op. at 22 (finding lack of SEC expertise "not sufficient to bypass the statutory remedial scheme where meaningful judicial review is otherwise available"); *Bebo*, 2015 WL 905349, at *4 ("Nor is it relevant . . . that the Commission may (or may not) lack jurisdiction to entertain constitutional claims. Appellate review in the court of appeals is sufficient." (footnote omitted)).

[22] *Bebo*, 2015 WL 905349, at *2. The *Tilton* court did not express any view on the argument's merits. *See Tilton*, slip op. at 23 ("Plaintiffs contend that it is unconstitutional . . . for the Commission to subject them to an enforcement action before the Commission's own [ALJ]. But that question is not for this Court to decide.").

[23] *Hill*, slip op. at 21-22; *Duka*, 2015 WL 1943245, at *7.

[24] *Duka*, 2015 WL 1943245, at *5.

[25] *Id.* (internal quotation marks omitted); *see also Hill*, No. 1:15-CV-1801-LMM, slip op. at 15 (hereinafter "*Hill*, slip op.") ("Plaintiff could raise his constitutional arguments only after going through the process he contends is unconstitutional—and thus being inflicted with the ultimate harm Plaintiff alleges (that is, being forced to litigate in an unconstitutional forum). By that time, Plaintiff's claims would be moot and his remedies foreclosed because the Court of Appeals cannot enjoin a proceeding which has already occurred.").

[26] *See Hill*, slip op. at 20 ("What occurs at the administrative proceeding and the SEC's conduct there is irrelevant to this proceeding which seeks to invalidate the entire statutory scheme."); *Duka*, 2015 WL 1943245, at *6 ("Duka does not assert an as-applied challenge to agency action in light of the facts of a specific case. Rather, she contends that Administrative Proceedings are unconstitutional in all instances—a facial challenge." (citations and internal quotation marks omitted)).

[27] *Duka*, 2015 WL 1943245, at *10.

[28] *Id.*

court concurred with *Duka* on this point, expressing "serious doubts" that the limits on removing ALJs are unconstitutional.[29] But it held that the ALJs are inferior officers whose appointment scheme likely violates the Appointments Clause, a question not raised in *Duka*.[30] Therefore, it issued an injunction.[31]

III. The Viability of Article II Challenges Going Forward

District courts have not been uniform in their approach to deciding Article II challenges to SEC administrative proceedings. That may change when the circuit courts have an opportunity to weigh in, and soon: the Seventh Circuit heard oral argument in *Bebo* on June 6th, the SEC has appealed *Hill* to the Eleventh Circuit, and the respondents in *Tilton* have filed a notice of appeal to the Second Circuit. If there is a circuit split, it is quite possible this battle may end up being decided by the Supreme Court.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Sean P. Tonolli at 202.862.8946 or stonolli@cahill.com; or Matthew V.H. Noller at 212.701.3366 or mnoller@cahill.com.

[29] *Hill*, slip op. at 42 n.12.

[30] *Id.* at 41-42.

[31] *Id.* at 43-44.