

June 3, 2016

Second Circuit Rules that Constitutional Challenge to Appointment of SEC Administrative Law Judges Must Be Adjudicated During Review of SEC's Final Order, and Not in a Separate District Court Lawsuit

Tilton v. SEC, No. 15-2103 (2d Cir. June 1, 2016), arose from an action in federal district court brought by Lynn Tilton and her investment firms ("Tilton"), who were respondents in an ongoing administrative proceeding before the Securities and Exchange Commission. In the district court, Tilton claimed that the SEC administrative law judge presiding over the SEC proceeding had been appointed in violation of the Appointments Clause of the United States Constitution. On appeal, the Second Circuit addressed whether Tilton could litigate her claim under the Appointments Clause in an immediate action in the district court, as she was trying to do, or whether Tilton could instead raise that claim only if and when she sought judicial review of a final order by the SEC. A divided panel of the Second Circuit held that Congress, by creating a comprehensive scheme for SEC administrative proceedings and for judicial review of the SEC's final orders, had implicitly precluded the district court from adjudicating Tilton's immediate parallel action.

Two federal courts of appeals—the D.C. Circuit and the Seventh Circuit—had previously reached the conclusion that the Second Circuit has now adopted. The issue, however, has divided the district courts. In light of the dissent in the Second Circuit and contrary rulings by some district courts, the question is likely to continue to generate some legal uncertainty and opportunities for defense challenges to SEC administrative proceedings brought outside the three circuits that have now resolved the issue.¹

Tilton nonetheless maintains, at least for now, the SEC's ability to bring administrative proceedings before SEC ALJs who were appointed through the current procedure. The SEC Staff has a higher rate of success in such administrative proceedings than the SEC has before federal courts.²

Background

Until 2010, the SEC had relatively limited authority to impose monetary sanctions through administrative proceedings. The Dodd-Frank Wall Street Reform and Consumer Protection Act, however, significantly expanded the SEC's authority in this area. After Dodd-Frank, in many cases, the SEC now has the option of filing a civil lawsuit in a federal district court or pursuing an administrative proceeding, either before the SEC itself or before a designated hearing officer—usually an ALJ. Where the SEC chooses to proceed before an ALJ, the proceeding is subject to two layers of review: the losing party may seek *de novo* review

before the Commission, and a party that is unsuccessful before the Commission can seek review in a federal court of appeals. Since 2010, the SEC has pursued an increasing number of claims through administrative proceedings—rather than in federal court.

Recently, however, a number of respondents in these administrative proceedings have brought parallel lawsuits in federal court challenging the SEC administrative proceeding. Courts have divided over whether a federal district court has jurisdiction over such lawsuits while the administrative proceeding is pending. *Compare Hill*, 114 F. Supp. 3d at 1310 (asserting jurisdiction over challenge to SEC administrative proceeding), with *Jarkesy v. SEC*, 803 F.3d 9, 30 (D.C. Cir. 2015) (rejecting jurisdiction over claims against the SEC).

In March 2015, the SEC filed an administrative claim against Tilton alleging that she misrepresented the value of loans made to distressed companies. Tilton filed a lawsuit in federal court in the United States District Court for the Southern District of New York seeking to enjoin the administrative proceeding. She alleged that the proceeding was invalid because the SEC's ALJs were hired in violation of the Appointments Clause. Tilton argued that SEC ALJs are inferior officers of the United States for purposes of the Appointments Clause, and that they must therefore be appointed by the President, the courts of law, or the heads of departments. In fact, SEC ALJs are appointed through bureaucratic procedures that do not appear to conform to the Appointments Clause. United States District Judge Ronnie Abrams dismissed the lawsuit in June 2015, finding that she lacked jurisdiction over Tilton's claims. The Second Circuit stayed the SEC's administrative proceeding pending its decision.

Second Circuit Majority Opinion

On June 1, 2016, a divided panel of the Second Circuit affirmed Judge Abrams's holding that the district court lacked jurisdiction over Tilton's lawsuit. The Second Circuit majority, in an opinion by Judge Robert D. Sack and joined by Judge Jon O. Newman, found that the legislative framework for the SEC's scheme for administrative and judicial review, including the Dodd-Frank Act and the Investment Advisers Act of 1940, did not expressly preclude federal district courts from exercising jurisdiction over the case. Therefore, it proceeded to determine whether the legislative framework did so implicitly.

The Second Circuit considered whether Tilton's Appointments Clause claim was the type of claim Congress intended to be reviewed within the SEC's scheme. In deciding this issue, the Second Circuit applied the three factors laid out by the Supreme Court in *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994): (1) the availability of meaningful judicial review; (2) whether the claim is "wholly collateral" to the administrative scheme; and (3) whether the claim falls outside of the agency's expertise.

The Second Circuit first found that the scheme offered Tilton meaningful judicial review. The ALJ's determination would be subject to review by the SEC, and subsequently by a federal court of appeals. The fact that judicial review was available in all cases adjudicated in the administrative proceedings was

critical to this determination. The Court also rejected Tilton's argument that the emotional and financial cost of the administrative proceeding would itself constitute a constitutional injury that was not redressable after the fact.

The Court next found that Tilton's Appointments Clause claim was not "wholly collateral" to the SEC's administrative scheme. The Court acknowledged that some courts have suggested that a claim is "wholly collateral" to the administrative proceeding unless it is "substantively intertwined" with the merits of the administrative proceeding. *Tilton*, No. 15-2103, at *26. The Second Circuit, however, agreed with the District Court that the Appointments Clause claim was not collateral to the administrative proceeding since it functioned as an affirmative defense.

The Court found that whether Tilton's Appointments Clause claim fell outside of the SEC's expertise was a "close question." *Id.* at *31. The Second Circuit, however, found that this factor also weighed in favor of dismissal. While the SEC does not have any unique expertise in analyzing Tilton's Appointments Clause claim, it could decide the substantive issues in Tilton's favor—which would obviate the need to address the constitutional claim.

Second Circuit Concurrence

Judge Newman wrote a concurring opinion adding one point to the Court's decision. He explained that dismissal was proper under the doctrine of "colorable jurisdiction." Under this concept, an order by a court must be obeyed and enforced even if the constitutionality of the statute under which the order was issued is in doubt. Judge Newman explained that Tilton's Appointments Clause claim raised a "fair question." *Concurrence* at *3. There was surely, however, "a plausible basis for arguing that her appointment is valid." *Id.* The SEC, therefore, had "colorable jurisdiction" to adjudicate the claims. Judge Newman's concurrence appears to suggest that, if the SEC lacked colorable jurisdiction, a separate collateral lawsuit in federal district court might have been proper.

Second Circuit Dissent

A dissent, authored by Judge Christopher F. Droney, focused primarily on whether Tilton's Appointments Clause claim was "wholly collateral" to the SEC's administrative scheme and whether the claim falls outside of the SEC's expertise. The dissent explained that the majority erroneously stripped these factors of any significance and turned them into mere procedural questions, which would effectively be satisfied any time there is a pending administrative proceeding.

The dissent explained that the resolution of Tilton's Appointments Clause claim was collateral to the underlying administrative proceeding. Under the majority's reasoning, any claim that could end the proceeding would not be "wholly collateral." The dissent explained that claims having no relation to the

securities laws, however, are collateral to an SEC administrative proceeding. Therefore, Tilton's challenge was collateral to the administrative proceeding.

The dissent also explained that the Appointments Clause claim was outside the agency's expertise. This factor weighs in favor of dismissal if the agency has expertise in resolving threshold questions that could obviate the need to resolve the constitutional question at issue. Whether the SEC's ALJs were hired in violation of the Appointments Clause logically precedes the resolution of the substantive issues within the SEC's expertise. Therefore, the substantive issues within the SEC's expertise were not threshold issues and Tilton's Appointments Clause claim was outside the agency's expertise.

Finally, the dissent agreed with the majority that the administrative scheme provided for meaningful judicial review. The dissent, however, explained that it did not weigh strongly enough to overcome the other two factors. Tilton would need to litigate her case in an administrative proceeding and receive a final adverse SEC order before obtaining judicial review. By that time, the proceedings would be finished, "rendering the possibility of obtaining an injunction moot even if the final Commission order is vacated." *Dissent* at *21.

Analysis

Tilton bolsters the SEC's efforts to pursue additional cases through administrative proceedings where its success rate is substantially greater than in federal court and procedural rules often place respondents at a substantial disadvantage. For example, short time deadlines and limits on discovery in administrative proceedings favor the SEC Staff which, unlike respondents, has had years to conduct its investigation and accumulate evidence. Some observers have commented on the potential appearance of unfairness associated with the SEC's decision to bring proceedings administratively "on its own turf" rather than in district court. That will continue to be a concern based on the Second Circuit's decision, which gives the SEC further leverage to bring aggressive actions in a friendly forum.

This decision makes it harder for respondents to challenge SEC enforcement actions before federal judges fully independent of the SEC. It means that, in order to challenge the appointment of SEC ALJs, a respondent must be willing to assume the business and reputational risks associated with a potential adverse decision by an SEC ALJ, a potential adverse decision by the Commission itself and the delay associated with review of the Commission's order in a federal court of appeals (during which time the Commission's order might not be stayed). The *Tilton* decision also brings the Second Circuit in line with the D.C. Circuit and the Seventh Circuit, which have both held that the SEC's administrative scheme precludes a parallel district court challenge.³

This issue, however, is still a relatively new one, and it remains to be seen whether appellate courts will come to a consensus or whether a split will emerge that requires Supreme Court resolution. The SEC has thus far succeeded in preventing any federal court of appeals from deciding an Appointments Clause

challenge to the procedure for appointment of SEC ALJs. At some point, however, a court of appeals is likely to decide an Appointments Clause claim, either because the court is reviewing a final order of the Commission or because the court agrees with the dissent in *Tilton* and allows a respondent in an SEC proceeding to raise the issue in federal court. If the SEC loses the Appointments Clause issue on the merits, it may be possible for respondents to collaterally attack past proceedings adjudicated by SEC ALJs who were unconstitutionally appointed.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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¹ Compare *Ironridge Glob. IV, Ltd. v. SEC*, 2015 WL 7273262, at *10 (N.D. Ga. Nov. 17, 2015) (asserting jurisdiction over lawsuit challenging SEC administrative scheme), and *Gray Fin. Grp., Inc. v. SEC*, 2015 WL 10579873, at *10 (N.D. Ga. Aug. 4, 2015) (same), and *Hill v. SEC*, 114 F. Supp. 3d 1297, 1310 (N.D. Ga. 2015) (same), with *Bennett v. SEC*, 2015 WL 9183445, at *10 (D. Md. Dec. 17, 2015) (dismissing challenge to SEC's administrative scheme for lack of jurisdiction).

² See Jean Eaglesham, *In-House Judges Help SEC Rack Up Wins*, Wall St. J., May 6, 2015, <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

³ *Jarkesy*, 803 F.3d at 30; *Bebo v. SEC*, 799 F.3d 765, 775 (7th Cir. 2015), cert. denied, 136 S. Ct. 1500 (2016).