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Challenges to SEC Administrative Proceedings Echo Complaints Against Arbitration

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After a sustained legal attack during the last couple of years on the U.S. Securities and Exchange Commission's expanded use of its administrative proceedings, it looks like the U.S. Supreme Court may finally weigh in on their constitutionality.

A division among federal appeals courts now exists over whether the SEC's in-house judges are appointed properly. At issue is an obscure provision of the U.S. Constitution known as the Appointments Clause, which details presidential appointments that require Senate confirmation. Courts have split on the issue of whether the SEC's Administrative Law Judges (ALJs) need Senate approval due to the significant discretion ALJs wield in presiding over enforcement hearings or whether ALJs should be viewed as agency employees.

But even if that issue is settled, more challenges await SEC administrative actions. Underlying these challenges have been arguments about fairness, equal protection, and due process. Defendants maintain that the deck is stacked against them in these proceedings and that they are unfairly deprived of important due process legal protections afforded them in federal court, such as the right to a jury trial and to conduct extensive discovery.

These arguments echo those long made by litigants in another context: namely, consumers and employees challenging arbitration clauses in contracts. In those cases, plaintiffs have argued that mandatory arbitration clauses curtail the rights to which they are entitled in federal or state court, and give unfair advantages to corporate defendants. This perennial issue is once again before the U.S. Supreme Court this term where employees are contesting arbitration clauses that prevent them from banding together to bring class actions.

Both lines of cases reflect attempts to overturn decades-long efforts to steer

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litigation out of federal and state court, and into a tribunal-type environment that individual litigants contend disfavors them in a variety of ways.

Increased Use of In-House Proceedings

The SEC has used administrative law proceedings for decades. However, their favorability within the agency grew considerably following the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which expanded the jurisdiction of the SEC's in-house administrative process to include people and entities not subject to the SEC's regulatory review. Before the passage of Dodd Frank, the SEC had to file cases against unregistered individuals or firms in federal court. The SEC's power to impose monetary penalties through administrative proceedings also was boosted by Dodd-Frank.

After the passage of Dodd-Frank, the SEC began filing significantly more cases in its administrative court than in federal court. Some observers have suggested that such increase was because the agency believed it would have more success in its own administrative proceedings than in federal court. In contested cases before SEC ALJs from October 2010 through March 2014, the SEC won 90 percent of the time, according to an analysis by The Wall Street Journal.

The SEC's increased use of administrative proceedings resulted in a wave of constitutional challenges. One of the most high-profile challenges has come from Lynn Tilton, head of Patriarch Partners, known as the "Diva of Distress" for her work on behalf of troubled companies. In March 2015, the SEC announced that it had brought an administrative proceeding against Tilton, alleging that she and her firms hid from investors the poor performance of loan assets in three collateralized loan-obligation funds under their management. The fraud, the SEC alleged, allowed Tilton to collect more than $200 million in improper fees.

Two days after the SEC commenced its administrative proceeding, Tilton sued the agency in the Southern District of New York, challenging the administrative law forum. Tilton's primary argument was that SEC ALJs were not properly appointed under the Appointments Clause of Article II of the U.S. Constitution.

But Tilton's complaint also found fault with the fairness of the SEC's administrative proceedings as compared to a court proceeding. It noted, for example, that unlike in federal court, administrative proceedings do not offer juries; discovery is limited; and the Federal Rules of Evidence do not apply. In addition, Tilton pointed out that the "SEC's Rules of Practice do not provide respondents the opportunity to test the SEC's legal theories before trial via motions to dismiss" and do not "allow respondents to assert counterclaims"—both of which are allowed in federal court.

The district court dismissed Tilton's complaint, finding that her objections must first make their way through the SEC's administrative review procedure. *Tilton v. SEC*, No. 15–cv-2472 (S.D.N.Y. June 30, 2015). In a 2-1 decision in June 2016, the U.S. Court of Appeals for the Second Circuit affirmed that decision. *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016). "By enacting the SEC's comprehensive scheme of administrative and judicial review, Congress implicitly precluded federal district court jurisdiction over the appellants' constitutional challenge," Judge Robert Sack wrote in the majority opinion. Id. "The litigant's financial and emotional costs in litigating the initial proceeding are simply the price of participating in the American legal system," he added. Id.

Due Process, Equal Protection Challenges

Using different arguments, another financial executive, Wing F. Chau, unsuccessfully challenged the SEC's use of administrative courts. Chau, a prominent manager of collateralized debt obligations (CDO), was charged, along with his firm, Harding Advisory, with misleading investors about the selection of assets in a CDO.

In a complaint also filed in the Southern District of New York, Chau argued that the SEC's decision to bring its case against him in its administrative court rather than in federal court deprived him of equal protection and due process under the Constitution. In the district court opinion dismissing the case in December 2014, the Honorable Lewis A. Kaplan acknowledged that the "growth of administrative adjudication, especially in preference to adjudication by Article III courts and perhaps particular in the field of securities regulation, troubles some." *Chau v. SEC*, No 14-cv-1903 (S.D.N.Y. March 19, 2014). But Judge Kaplan ruled that the court lacked jurisdiction to hear

Chau's claims, which had not fully run their course through the SEC administrative review procedure.

In December, the Second Circuit unanimously affirmed the *Chau* decision, relying on its previous ruling in *Tilton*. The Second Circuit found that Chau had not shown that his constitutional injury was irreparable since he would be entitled to seek review from an appeals court at the conclusion of the SEC's administrative proceeding. It also rejected Chau's claims that the SEC could not adequately present a record sufficient for review.

"While different rules of discovery govern SEC administrative proceedings, the only specific instance of being denied discovery that Plaintiffs identify is the administrative law judge's decision to preclude certain depositions and access to certain documents on privilege grounds," the panel wrote. "As the district court properly determined, however, that ruling was not unique to the SEC because a district court could have reached the same conclusion." *Chau v. Lewis*, 771 F.3d 118, 121 (2d Cir. 2014).

The fate of legal challenges to the SEC's administrative courts may now rest with the U.S. Supreme Court, which is faced with a circuit split. In December, a divided panel from the Tenth Circuit in *Badimere v. SEC* held that the SEC's five administrative law judges are subject to the Appointments Clause and had been unconstitutionally appointed. The ruling was in direct opposition to a 2015 D.C. Circuit opinion, *Lucia v. SEC*, finding that SEC administrative judges are employees and not subject to the Appointments Clause.

Arbitration Clauses

Constitutional questions also have been part of continued challenges to the enforceability of arbitration clauses in consumer and employment contracts. Buoyed by the Federal Arbitration Act, which establishes "a liberal policy favoring arbitration agreements," companies have been increasingly requiring their employees and customers to sign contracts in which they agree to resolve their disputes through arbitration and relinquish their right to bring an action in court. *Moses H. Cone Memorial Hospital v. Mercury Constr.*, 460 U.S. 1, 24 (1983).

In legal challenges, plaintiffs have argued, with generally little success, that arbitration favors companies and forces individuals to unfairly give up their rights. In recent years, the U.S. Supreme Court has addressed the enforceability of these arbitration provisions as applied to consumers and others who band together to bring class actions. In *AT&T Mobility v. Concepcion*, a 2011 U.S. Supreme Court case about consumer cellular telephone contracts, the Supreme Court held that states must enforce arbitration agreements even if they prohibit consumers from banding together to bring claims. 131 S. Ct. 1740 (2011). The U.S. Supreme Court bolstered the use of arbitration agreements again in its 2013 *American Express Co. v. Italian Colors Restaurant* decision, holding that courts could not invalidate arbitration agreements with class-action waivers, even when bringing an arbitration claim would exceed the cost of recovery. 133 S. Ct. 2304, 2314 (2013)

In its current term, the U.S. Supreme Court is set to hear three cases regarding whether employment agreements requiring employees to resolve all work-related claims through arbitration are enforceable under the Federal Aviation Administration (FAA), notwithstanding certain provisions of the National Labor Relations Act (NLRA). The Seventh and Ninth Circuit Courts of Appeal have held that the class-action waivers are prohibited under the NLRA, while three other appellate courts have ruled the opposite. Those courts have found that the waivers are enforceable under the FAA.

Conclusion

As the challenges to SEC administrative proceedings continue, expect those challenges increasingly to include the due process arguments that consumers and employees have made against arbitration agreements. While those challenges to arbitration agreements largely have been unsuccessful, challenges to SEC administrative proceedings may enjoy greater success relying on the Appointments Clause argument backdropped by due process concerns.

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