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SEC Corner

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U.S. Supreme Court Deals Latest Setback to Federal Government's Use of Administrative Law Judges

Michael D. Birnbaum, Haimavathi V. Marlier, Gerardo Gomez Galvis, and Justin Young*

In this article, the authors explain that a recent decision by the U.S. Supreme Court created doubt about the administrative law judge procedure on which the Securities and Exchange Commission so critically relies.

In a setback to the use of administrative law judges (ALJs) by the Securities and Exchange Commission (SEC) and other federal agencies to conduct in-house enforcement proceedings, the U.S. Supreme Court recently issued a unanimous decision in *Axon Enterprise, Inc. v. Federal Trade Commission, et al.*,[1] holding that federal district courts can hear collateral constitutional challenges to administrative enforcement actions brought by the SEC and the Federal Trade Commission (FTC) before there is a final agency adjudication on the merits.

Background and Majority Opinion in *Axon*

The *Axon* decision involved administrative SEC and FTC proceedings where both respondents claimed "that the agencies' [ALJs] are insufficiently accountable to the President, in violation of separation-of-powers principles." In each case, the respondent sued in federal district court, before an ALJ decision, seeking to enjoin the respective commission's proceeding. Both challenges resulted in dismissal from the district courts for lack of jurisdiction.

On appeal from those decisions, the U.S. Courts of Appeals for the Fifth and Ninth Circuits split. While the Ninth Circuit, reviewing the FTC case, agreed with the district court "that Axon's constitutional challenges fell within the FTC Act's scheme,"[2] the Fifth Circuit disagreed on the equivalent SEC question because

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"Cochran's removal power claim is not the type of claim Congress intended to funnel through" the statutory-review scheme set forth in the Securities Exchange Act of 1934 (Exchange Act).[3]

Resolving the circuit split, Justice Elena Kagan delivered the Court's unanimous opinion and wrote that "[t]he ordinary statutory review scheme does not preclude a district court from entertaining these extraordinary claims." In so ruling, the Court analyzed whether these collateral challenges were "of the type" Congress intended the FTC Act/Exchange Act's "statutory review schemes" to reach, as determined by three factors set forth in *Thunder Basin Coal Co. v. Reich*.

The Court described these three factors as: "First, could precluding district court jurisdiction foreclose all meaningful judicial review of the claim? Next, is the claim wholly collateral to the statute's review provisions? And last, is the claim outside the agency's expertise?"[4]

In answering this three-prong test, the Court first found that precluding district court jurisdiction would foreclose all "meaningful judicial review." Although Axon and Cochran could eventually obtain review of their constitutional claims by appealing the adverse agency actions to courts of appeals (as prescribed by the Exchange Act and FTC Act), the injury alleged here "is impossible to remedy once the proceeding is over" because "[t]he harm Axon and Cochran allege is being subjected to unconstitutional agency authority," that is, "a proceeding by an unaccountable ALJ." Thus, judicial review of these types of constitutional claims by the courts of appeal "would come too late to be meaningful."

Second, the Court found that the constitutional challenges were "collateral" to Axon's and Cochran's enforcement actions because their "separation-of-powers claims do not relate to the subject of the enforcement actions—in the one case auditing practices, in the other a business merger." Rather, "they are challenging the Commissions' power to proceed at all," which is collateral to the agencies' claims.

Third, the Court found that Cochran's and Axon's claims are "outside the Commissions' expertise." Axon and Cochran raised "standard questions of administrative and constitutional law, detached from considerations of agency policy" that are within the purview of the SEC and FTC ALJs. And even if the agencies' ALJs were subject matter experts on Axon and Cochran's constitutional

claims, their "here-and-now" injury regarding "subjection to all agency authority" would remain.

Finding that "[a]ll three *Thunder Basin* factors pointed in the same direction," the Court concluded that these claims "are not 'of the type' the statutory review schemes reach" and "[a] district court can therefore review them."

Concurring Opinions by Justices Thomas and Gorsuch

While agreeing that "structural constitutional claims need not be channeled through the administrative review schemes," Justice Clarence Thomas questioned the constitutional ability of the SEC and FTC to use ALJs to adjudicate "private rights" at all.[5] Justice Thomas wrote that "when private rights are at stake," including life, liberty, and property, then "full Article III adjudication is likely required." According to Justice Thomas, these adjudications likely involved "private rights" because Cochran faced "significant monetary fines" from the SEC's $22,500 civil penalty and because "the FTC seeks to require Axon to transfer intellectual property to another entity." Such issues "likely must be adjudicated by Article III courts and juries."

Justice Gorsuch concurred in the Court's judgment but not in its opinion.[6] Justice Gorsuch described the *Thunder Basin* test as a "throw-it-in-a-blender approach to jurisdiction that imposes serious and needless costs on litigants and lower courts alike." According to Justice Gorsuch, Axon and Cochran had "already endured multi-year odysseys through the entire federal judicial system—and no judge yet has breathed a word about the merits of their claims." As a result, according to Justice Gorsuch, "the bulk of agency cases settle," in part because agencies use the complexity of law "to extract settlement terms they could not lawfully obtain any other way." Moreover, according to Justice Gorsuch, the lack of judicial access is not "a small thing" when agencies like the SEC "employ relaxed rules of procedure and evidence—rules they make for themselves." As noted above, Justice Gorsuch highlighted "just how tilted this game is" by noting that the "vast majority of SEC cases settle" and observing that "[f]rom 2010 to 2015, the SEC won 90% of its contested in-house proceedings compared to 69% of the cases it brought in federal court."

Justice Gorsuch explained that he would have instead resolved the issue under 28 U.S.C. § 1331, which provides that "district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States." According to Justice Gorsuch, while Congress has the authority to define the scope of federal jurisdiction, the relevant statutes here—the Exchange Act and FTC Act—provide for exclusive appellate court review only as to the merits of agency adjudications. Thus, "Section 1331 grants district courts the power to hear Ms. Cochran's and Axon's claims and no other law takes that power away."

Summary

- In a unanimous decision, Justice Kagan reasoned that statutory review schemes set Exchange Act and FTC Act do not displace federal district courts' jurisdiction to adjudicate collateral constitutional claims against the SEC and FTC in-house proceedings.
- The *Axon* decision means that litigants can raise constitutional challenges to contested SEC administrative proceedings—challenging the apparent lack of restrictions on presidential removal of ALJs, for example—before the SEC has rendered a final decision on the merits. Under the Exchange Act, the SEC can elect whether to file enforcement actions in federal district court, where it will be heard by an Article III judge, or by bringing administrative proceedings, to be heard by an ALJ. The *Axon* decision means, as a practical matter, that litigated SEC enforcement actions will almost entirely be brought in federal court, except for the rare matters where only administrative relief is available. This could mitigate a perceived "home court advantage." In a concurring opinion, Justice Neil Gorsuch noted that such in-house proceedings are a "tilted [] game," where "[f]rom 2010 to 2015, the SEC won 90% of its contested inhouse proceedings compared to 69% of the cases it brought in federal court."
- The *Axon* decision did not address the merits of the constitutional challenges brought against the FTC and SEC, but it follows another recent setback to the SEC's in-house proceedings in *Jarkesy v. SEC*, where the U.S. Court of

Appeals for the Fifth Circuit ruled that the SEC's use of ALJs is unconstitutional.[7] While the SEC has asked the Supreme Court to review the *Jarkesy* decision,[8] the Court has yet to determine whether it will hear the appeal. Nevertheless, the *Axon* and *Jarkesy* opinions mark a trend of recent decisions that will likely continue to pressure the SEC into filing claims in federal district courts rather than in house.

- Courts are already seeing post-*Axon* challenges to ALJ proceedings. In what appears to be the first constitutional challenge following the *Axon* decision, a Georgia-based investment adviser, who has been subject to an administrative SEC action since 2016, sued the SEC alleging that its in-house proceeding denies him a right to a fair trial and uses unconstitutionally appointed ALJs.[9]

Conclusion

The practical and immediate impact of the *Axon* decision is that the SEC likely will be reluctant to bring cases before its ALJs when respondents can collaterally attack the constitutionality of the entire proceeding in federal court. This consideration, combined with the pending appeal in *Jarkesy*, marks a period of uncertainty for the SEC as it determines how to navigate trending law that casts doubt about the ALJ procedure on which it so critically relies.

Notes

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1. No. 21-1239 (U.S. Apr. 14, 2023).

2. *Id.* (citing Axon Enter., Inc. v. FTC, 986 F.3d 1173, 1186 (9th Cir. 2021), cert. granted in part, 142 S. Ct. 895 (2022), and rev'd and remanded, No. 21-1239, 2023 WL 2938328 (U.S. Apr. 14, 2023)).

3. *Id.* (quoting Cochran v. SEC, 20 F.4th 194, 207 (5th Cir. 2021), cert. granted sub nom., 142 S. Ct. 2707 (2022), and aff'd and remanded sub nom., No. 21-1239, 2023 WL 2938328 (U.S. Apr. 14, 2023)).

4. *Id.* (citing Thunder Basin Coal Co. v. Reich, 510 U.S. 200, 212-13 (1994)) (internal citations and quotations omitted).

5. *Id.* (Thomas, C., concurring).
6. *Id.* (Gorsuch, N., concurring).
7. No. 20-61007 (5th Cir. May 18, 2022).
8. Petition for Writ of Certiorari, SEC v. Jarkesy, No. 22-859 (U.S. Mar. 8, 2023).
9. Complaint, Gibson v. SEC, No. 1:23-cv-01723 (N.D. Ga. Apr. 18, 2023).