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The SEC's ALJs: Channeling the Appointments Clause

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Inside

The SEC's ability to conduct administrative proceedings instead of or in addition to bringing civil actions in federal court has come under attack as the Commission uses its Dodd-Frank Act powers to impose civil penalties against unregistered persons. In the last year, respondents in ten administrative proceedings have sued the SEC in federal courts claiming the agency's administrative law judge regime violates the U.S. Constitution. Some of the cases reference news reports that the SEC's home-field advantage is aided by the alleged bias of its ALJs for the agency's enforcement division. Federal court decisions on the jurisdictional and merits claims in these cases may not only impact the SEC's ALJ program, but could suggest lines of attack on the use of ALJs by other federal agencies.

Introduction

Dodd-Frank Act Section 929P may be the latest catalyst to reignite the debate over the use of administrative law judges by the SEC, but the perception that the SEC, like many other federal agencies, has a home-field advantage because its administrative proceedings are subject to much looser procedural and evidentiary rules than are federal courts is not a new claim. What is perhaps new is the ferocity with which a small but growing number of respondents in SEC administrative proceedings have chosen to take on the agency in federal courts. A few cases fell apart after the respondents settled with the SEC, but many other respondents appear determined to pursue their court challenges into the federal appeals courts.

What's at Stake?

The impact of a court decision invalidating federal agency ALJs can be glimpsed in Justice Breyer's dissent in the Supreme Court's *Free Enterprise* decision, a case that lies at the heart of claims disputing the SEC's ALJs. Justice Breyer detailed the numbers of ALJs by agency and it is not difficult to infer from his data just how many administrative cases could be shifted to federal courts, or could otherwise be upset, while agencies bring their ALJ regimes into compliance with constitutional precepts, if ordered to do so by the courts.

The SEC's ALJ regime has roots in the Administrative Procedure Act and the Commission's rules of practice. But as a practical matter, the federal Office of Personnel Management plays a key role too by making qualified ALJs available to be hired by agencies like the SEC. In fact, one judge has already suggested that a solution to the SEC's ALJ "problem" may be for the Commission to appoint its own ALJs.

The SEC's In-House Court

Rules 101(a)(5) and 110 of the Commission's rules of practice define key terms and state that the presiding officer in all proceedings before the Commission must be either the Commission itself or a hearing officer. If a hearing officer is to be an ALJ, then the SEC's chief ALJ selects the presiding ALJ under another rule that details the chief ALJ's delegated authorities.

An SEC ALJ generally has authority under Rule 111 to take any necessary and appropriate action in performing his duties. The rule provides a non-exhaustive list of specific duties that is supplemented by still other Commission rules of practice. One of the most important tasks for an SEC ALJ is to issue an initial decision as required by Rule 360(a)(1). The respondents challenging the SEC's ALJ regime in federal courts list these authorities and more to come up with over 40 different things the agency's ALJs can do.

A respondent who loses before an ALJ can petition the Commission to review the ALJ's findings under Rule 410(a). Commission Rule 411 spells out how the commissioners go about reviewing an initial decision, while Rule 452 permits them to accept additional evidence. Under Rule 360(d)(2), if no respondent in a matter has petitioned for review of an initial decision and the Commission did not seek review on its own, the Commission will issue an order making the initial decision final. The next step would be for a respondent who lost before the Commission to file a petition for review of the Commission's opinion in a federal appeals court.

Channel Stuffing?

No analogy is perfect, but the several individuals challenging the constitutionality of the SEC's ALJ regime might not object to one that invokes the concept of channel stuffing—the practice by which a company floods product channels in order to exaggerate its revenues. Here, the challengers would point out that the SEC has upped the number of its ALJs, and it may be pushing more cases into the agency's administrative machinery than in the past, at least in part because of its new Dodd-Frank Act powers.

It is this "channeling" that gives rise to the jurisdictional questions that have hung up the federal court suits disputing the SEC's in-house enforcement program. In the administrative law context, channeling refers to Congress's intent that certain types of cases be "channeled" through an agency's in-house process before they may be reviewed by a federal court, typically an appeals court. The suits against the SEC have focused on whether the constitutional claims—that the SEC's ALJs are inferior officers appointed in violation of Article II of the U.S. Constitution—are of a type that can be channeled through the Commission first, or whether they can be heard by federal district courts now.

Channeling may have a number of advantages, including giving federal agencies with technical expertise the first chance to decide regulatory enforcement matters. But a more practical goal of channeling is the avoidance of claim splitting. Despite the general rule favoring channeling of matters through a government agency, three factors may salvage district jurisdiction in situations where Congress would not have intended preclusion.

Fairly Discernable?

Although a heightened standard can apply where Congress has by law clearly denied all avenues for judicial review of constitutional claims, the emphasis in the cases against the SEC is whether an exception to the statutorily prescribed channeling of review to federal appeals courts is to be made for the specific claims against the SEC. That analysis, under the Supreme Court's more recent *Elgin* opinion, turns on whether it is fairly discernable from a law's text, structure, and purpose that Congress intended for claims of the type presented to be heard first by the agency before judicial review by a federal appeals court.

The high court's earlier *Thunder Basin* decision—more on this later—also referred to the "legislative history" of the statutory scheme. This additional inquiry prompted Justice Scalia, joined by Justice Thomas, to dissent stating that an examination of the statute's legislative history was "unnecessary" to that case's outcome. The majority opinions in post-*Thunder Basin* cases shy away from explicitly mentioning legislative history, although Justice Alito's *Elgin* dissent includes the full quote from *Thunder Basin*.

Exchange Act Section 25(a) is the reference point for the suits challenging the SEC's ALJs. That provision says a person who is aggrieved by a final order issued by the Commission may file a petition for review in either the D.C. Circuit, or in the federal appeals court where they reside or have their principal place of business. Exchange Act Section 28(a)(2) contains a savings clause that specifies the Act's rights and remedies are in addition to any other legal or equitable rights or remedies that may be available. The SEC says claims about its ALJs must be channeled through the Exchange Act route, while those disputing the constitutionality of the agency's ALJs argue the district courts should hear their cases now.

Four Supreme Court cases loom large for both the SEC and the challengers. Each side can claim two cases going their way, although how the courts ultimately resolve the suits over the SEC's ALJs will likely depend on a close reading of Exchange Act Section 25 and a comparison to the specific statutory schemes in the Supreme Court's analogs. As a result, the Supreme Court's opinions in *Elgin*, *Free Enterprise*, *Thunder Basin*, and *McNary* are only examples within a branch of constitutional law that puts a premium on subtle factual differences.

The Challengers' Favorite Precedents

The challengers rely heavily on the Supreme Court's *Free Enterprise* and *McNary* opinions. Interestingly, Justice Kagan made the losing argument for the government in *Free Enterprise* when she was Solicitor General. Two years later in *Elgin*, one of two cases relied on by the SEC, now Justice Kagan joined Justice Alito's dissent, while the majority opinion penned by Justice Thomas pulled in Justice Breyer who had dissented in *Free Enterprise*. (Justice Sotomayor also voted with the *Elgin* majority after previously joining Justice Breyer's *Free Enterprise* dissent. Among the currently active justices, only Justice Ginsburg dissented in both *Elgin* and *Free Enterprise*, the high court's latest cases in this area).

According to the challengers, the Supreme Court's *Free Enterprise* decision means game over for the SEC's ALJs. The court held that Exchange Act Section 25 did not provide the exclusive mode for getting the question of the PCAOB's constitutionality before federal courts. The challengers argue that this case alone is sufficient to counter the SEC's argument that Section 25 nevertheless spells out the only path to judicial review of the Article II issue regarding the agency's ALJs. But it should not be forgotten that *Free Enterprise* was a five to four decision that left many unanswered questions about the court's holding.

The Sarbanes-Oxley Act of 2002 created the PCAOB to adopt audit standards for public companies and to impose sanctions for violations because existing audit oversight failed to prevent the Enron and WorldCom accounting scandals in the late 1990s and early 2000s. The PCAOB's five member board, which is appointed by the Commission, emulates the self-regulatory organization model that pervades federal securities law.

The *Free Enterprise* majority noted that SOX treated PCAOB board members as non-government officers or employees under federal law in order to take them out of the government pay scale for purposes of offering much higher salaries to attract top talent. But the parties in *Free Enterprise* also agreed that PCAOB board members are government officials for constitutional purposes. The crux of the problem was that both the SEC commissioners and the PCAOB board members were subject to good cause removal only. The challengers argued, and a majority of the court agreed, that this arrangement violated the Article II appointments clause (more on Article II below).

Nevada accounting firm Beckstead and Watts LLP and industry group Free Enterprise Fund sued the PCAOB in federal district court alleging the unconstitutionality of the PCAOB's board structure. The accounting firm had been the subject of a PCAOB investigation, but disputed only the board's existence, not any sanctions.

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The majority opinion held that the accounting firm and industry group would be denied meaningful access to judicial review if forced to await Commission action that would permit them to petition for review of their constitutional claims much later in the federal appeals courts. The court reasoned that Section 25 did not limit jurisdiction granted to the district courts under other laws. Moreover, although Section 25 contemplated "Commission action," some PCAOB board actions did not result in a Commission order or rule.

In reaching these conclusions, the majority emphasized the meaningful judicial review factor from its earlier *Thunder Basin* opinion. But the court also noted that a party need not "bet the farm…" by opting to incur a regulatory sanction in order to get the attention of the federal courts. Also, the accounting firm's claims were wholly collateral to any of its other interactions with the PCAOB and agency review of the constitutional claims would be beyond the SEC's expertise.

The challengers also rely on *McNary*. That case required the Supreme Court to interpret parts of the Immigration Reform and Control Act of 1986, a law that amended the Immigration and Nationality Act, to create twin amnesty programs to deal with the flow of illegal immigrants into the U.S. Of special concern, was

whether the reform law barred district court jurisdiction over claims related to the special agricultural workers amnesty program designed to help farm workers by letting them apply for lawful temporary resident status, with the possibility of eventually obtaining permanent resident status. To counter immigrants' fears about deportation, the law stated that a SAW application could not be used to identify an alien for deportation.

The *McNary* majority said the case should turn on the narrow question of whether the INA amendment barring judicial review of non-deportation individual determinations likewise barred judicial review of claims that the agency engaged in unconstitutional practices and procedures. Language referring to "a determination," "an application," or "a denial" implied that the law applied to single acts such as individual SAW status denials and not to constitutionally-based practice and procedure claims.

As a result, the court held that the revised law did not bar judicial review because the case did not involve a denial of a particular application. The court noted that Congress could have, but did not, use broader language to clarify that all claims must be channeled through the agency. This part of the court's holding could give the government in the SEC ALJ cases an inroad to argue that *McNary* is limited by its focus on the precise language of the reform law. But the majority in *McNary* also discussed how the reform law was akin to a denial of meaningful judicial review.

The court favorably cited its *Bowen* opinion for the view that Congress would not have intended to bar judicial review in *McNary*. One highly persuasive factor was that the *McNary* immigrants would have had to surrender for deportation in order to get the attention of federal courts. Another factor that showed a denial of meaningful judicial review was the fact that the immigrants only asked to have their cases reopened under improved agency procedures rather than for a declaration they were entitled to SAW status.

Yet another factor was the likelihood the reviewing court, if the channeling procedure was followed, would lack a proper record on which to make a decision. But the majority embraced the reasoning of amicus the American Bar Association that channeling works best when the fact finding to be done by an agency and the district court would be redundant.

Cases Helping the SEC

By contrast, the SEC leans heavily on the Supreme Court's *Elgin* and *Thunder Basin* decisions. In *Elgin*, the court said the Civil Service Reform Act of 1978 barred district court jurisdiction over claims that a law prohibiting a federal executive agency from hiring a person who failed to register under the Military Selective Service Act was an unconstitutional bill of attainder and discriminated on the basis of sex.

The CSRA permitted review of agency actions taken against employees in the competitive or excepted service, which can be appealed to the Merit Service Protection Board upon final adverse agency action. In *Elgin*, the petitioner appealed to the MSPB, which then assigned his matter to an ALJ, who declined jurisdiction due to an absolute statutory bar and because of the ALJ's inability to decide the constitutionality of a statute. The petitioner then filed a law suit in a federal district court instead of petitioning for review by either the full MSPB or the Federal Circuit, as required by the CSRA.

According to the *Elgin* court, the CSRA stated in "painstaking detail" how covered employees should go about getting their claims reviewed thus making it fairly discernable that Congress intended to channel those matters through the agency and then to the Federal Circuit. Likewise, the purpose of the CSRA was to avoid claim-splitting and needless duplication of agency and judicial efforts. Moreover, none of the anti-preclusion factors (discussed below) was present in *Elgin*.

Thunder Basin dealt with pre-enforcement claims arising from the threatened application of the Federal Mine Safety and Health Amendments Act of 1977 by the Mine Safety and Health Administration, an agency within the Department of Labor. Under the Mine Act, timely challenges to enforcement actions are first heard by an ALJ, whose proposed civil penalties can be reviewed *de novo* under six statutory criteria by the Federal Mine Safety and Health Review Commission, which is independent of the DOL, and by the designated federal appeals courts. The Supreme Court said the Mine Act barred district court jurisdiction.

As background, the Mine Act provided that periodic mine safety inspections done by the labor secretary's representative may be attended by representatives of the operator and the miners who work at the site. In *Thunder Basin*, the employer refused to comply with a regulatory requirement that it post information about the miners' representatives because the miners had chosen to be represented by members of the United Mineworkers of America who did not work at the mine.

Rather than take the review path set by the Mine Act, the employer sued in a federal district court alleging due process violations prior to getting a letter from the MHSA demanding compliance. The employer first won

an injunction against agency enforcement, but then lost in the Tenth Circuit, which found the Mine Act offered a comprehensive review scheme that could not be avoided by going instead to the federal courts.

The Supreme Court noted that the Mine Act was "facially silent" about the handling of *pre*-enforcement claims, but still found the comprehensive statutory scheme included these claims. Moreover, the Mine Act explicitly gave federal district courts jurisdiction over two kinds of claims, while denying that route to other claims. The majority also were persuaded by the Mine Act's legislative history (Justice Scalia dissented on this and a few other points), which suggested a prior version of the law that permitted district court jurisdiction made it hard to collect civil penalties.

Anti-Preclusion Factors

Sometimes federal courts have applied three factors to salvage district court jurisdiction in the face of a law that has a comprehensive review scheme. While the factors can work as a two-way street, the Supreme Court in *Free Enterprise* (quoting *Thunder Basin*) couched them in terms of a presumption that Congress does not intend for a law to preclude district court jurisdiction if the factors are present.

As a result, a district court may exercise jurisdiction over a case challenging an agency's action if (i) a finding that preclusion under a statutory scheme devised by Congress would foreclose all meaningful judicial review, (ii) the claims are wholly collateral to the law's review provisions, and (ii) the claims are beyond the agency's expertise.

— Meaningful Judicial Review

The meaningful judicial review prong is generally considered by courts to be the most important anti-preclusion factor. A recurring theme among the SEC's challengers is that they may achieve at best a Pyrrhic victory if they are forced to defend themselves in an administrative proceeding that is later found to be unconstitutional. The Seventh Circuit in *Bebo* rejected this theory in a case challenging the SEC by following Supreme Court precedent that cautioned against automatically permitting suits of this type to be brought in district courts. Some district judges in the SEC ALJ cases have taken the opposite view.

The challengers also argue that constitutional claims are barred in SEC administrative proceedings. But a few judges, such as in *Tilton*, point out that these claims can be raised before the SEC as affirmative defenses. Likewise, the Seventh Circuit noted in *Bebo* that the challenger there had raised her district court claims as affirmative defenses in the SEC administrative proceeding. But the affirmative defense option may impact the analysis of whether the federal court claims are wholly collateral to the administrative proceeding.

— Wholly Collateral

As for the wholly collateral factor, the only federal appeals court (the Seventh Circuit in *Bebo*) that has issued an opinion regarding district court jurisdiction over claims about the SEC's ALJs found that Congress intended those claims to be channeled through the administrative process. But the Seventh Circuit panel noted two possible views on how to determine if a claim is wholly collateral, each of which can trace its roots to one or more Supreme Court opinions.

The meaningful judicial review prong is generally considered by courts to be the most important anti-preclusion factor.

Under one approach, the panel said a court might look at the relationship between the constitutional claim's merits and the factual allegations in the administrative proceeding. An alternative approach would be to ask if the constitutional claim is being brought just to upend whatever action the agency took in the administrative proceeding.

The Seventh Circuit said the first approach relies on *Free Enterprise* and found its way into decisions backing district court jurisdiction in the SEC ALJ cases *Charles Hill* and *Duka* (the jurisdictional opinion). Meanwhile, the panel found support for the second approach in *Elgin*, which it said played a role in denying district court jurisdiction in the *Tilton* case and the lower court's decision in *Bebo*. Still, the Seventh Circuit found that Congress intended cases like Laurie Bebo's to go through the administrative process first, despite assuming Bebo's claim was wholly collateral and noting that the Supreme Court never said any of the three factors was "sufficient" to require district court jurisdiction.

Elsewhere, Judge Abrams in *Tilton* said the wholly collateral issue there was a "close question." The judge said the SEC's argument based on *Elgin* (federal case as "vehicle" to raise constitutional claims) short-changed *Elgin*'s discussion of the types of proceedings that are routinely handled by federal agencies. Judge Abrams said Lynn Tilton's structural claims about the SEC's administrative enforcement regime were hardly routine agency matters.

But Judge Abrams went on to say that Tilton had raised her constitutional claims as an affirmative defense, which made them no longer collateral to any order or rule the Commission might issue in her agency proceeding. But this view raises a possible conundrum: can or must a respondent in an administrative proceeding forgo an affirmative defense in order to bring a case in a district court? Judge Abrams said only that Tilton was unlike challengers in other cases who had to "bet the farm" in order to be heard in federal court.

—Agency Expertise

In *Free Enterprise*, the Supreme Court said the accounting firm's claims were beyond the SEC's expertise. This conclusion flowed from the majority's effort to distinguish some of its prior opinions. In *Thunder Basin*, the court had said the anti-preclusion factors were inapt because the statutory scheme provided for meaningful judicial review. The court went on to note that even if the MSHRC had little knowledge of laws other than the Mine Act, it may still have knowledge that could be "brought to bear" on statutory issues in the matter.

Moreover, the *Thunder Basin* majority had implied that a federal agency may be able to wade into matters that call for constitutional interpretations of laws. After acknowledging that agencies generally lack jurisdiction to pass on the constitutionality of federal laws, the majority said that rule was not "mandatory," and that the MSHRC had previously dealt with these types of issues a few times. The majority also seemed to think it was important that the MSHRC was an independent commission whose work only dealt with the Mine Act.

Free Enterprise also was different from the court's *Ruzicka* opinion. In *Ruzicka*, the agency had expertise about the milk industry that bore on the matter. But even though the government in *Free Enterprise* relied on *Ruzicka*, the majority said no similar agency expertise was needed to decide the constitutional claims lodged against the PCAOB's existence.

As for the SEC, its commissioners recently issued two opinions in administrative proceedings in which a majority of the commissioners found the agency's ALJs were employees beyond the reach of Article II. The commission opinions also rejected claims that the SEC's ALJs were not properly appointed, and one of the opinions further rejected claims the agency's ALJs are prone to bias in favor of the SEC's enforcement division. These views are likely to be tested in the several pending federal appeals dealing with the SEC's ALJs possibly via letters offering the courts supplemental authorities. One issue raised by the commission's opinions is its expertise to decide these types of claims.

Savings Clause

What impact should the presence of a savings clause in a law have on the determination of whether a district court can exercise jurisdiction over claims about an agency's enforcement process? In *Thunder Basin*, the Supreme Court not only held the statutory scheme there barred district court jurisdiction, it also distinguished the case from its earlier *Gardner* opinion, in which the court said a savings clause in the Federal Food, Drug, and Cosmetic Act preserved district court jurisdiction.

According to the *Thunder Basin* majority, the FDCA's legislative history showed that the savings clause in *Gardner* was intended to ensure that "traditional" forms of review would continue to exist alongside the agency's review process. But in *Thunder Basin*, the Mine Act explicitly foreclosed similar review options in order to correct the prior version of the law which had produced a confused array of actions that frustrated the earlier law's purposes. The *Thunder Basin* court also noted that the Mine Act case was procedurally distinct from *Gardner* because the *Gardner* petitioners did not ask to stay enforcement of a disputed regulation during judicial review as did the Mine Act petitioners in *Thunder Basin*.

The *Charles Hill* case disputing the legality of the SEC's ALJs offers an example of how the savings clause argument may play out in the securities law context. Charles Hill's lawyers argued in their latest briefs to the Eleventh Circuit that the presence of a savings clause in Exchange Act Section 28(a)(2) can preserve district court jurisdiction. That provision, subject to limits in another subsection, states that the rights and remedies allowed under the Exchange Act are in addition to all other legal or equitable rights and remedies that may exist.

Facial Versus As-Applied Claims

Cases like those disputing the legality of the SEC's ALJs have perplexed courts because of how they try to divvy

up constitutional claims into facial and as-applied buckets. Often times, a party urging district court jurisdiction will cast their claims as facial ones rather than as-applied ones to emphasize their objection to the entirety of the law on constitutional grounds, and not how the law was specifically applied to them. But even the Supreme Court has admitted difficulty in making the distinction between facial and as-applied claims.

The court's *Elgin* opinion is a good example. At oral argument, several justices, including Chief Justice Roberts, mentioned the difficulties in shunting cases into facial and as-applied buckets. Justice Sotomayor asked the would-be employee's lawyer if facial challenges would go to the district court, while as-applied ones go to the agency. Justice Kagan explored whether the line should be based on what claims the agency can hear. Justice Scalia asked why not decide as-applied issues first, and then facial ones, which can then be taken to the federal appeals courts.

But according to the *Elgin* majority opinion, the dividing line between facial and as-applied claims ranges from "hazy" to "incoherent." Ultimately, the court in *Elgin* said the law there which limited federal court jurisdiction should be understood to divide cases based on the type of employee and the employment action rather than the constitutional aspects of the claims.

Those disputing the SEC's enforcement regime tend to see their claims as facial ones. In the only appellate decision in the SEC ALJ cases to date, the Seventh Circuit in *Bebo* ran into many of the same problems of interpretation as the Supreme Court did in *Elgin*. Specifically, the Seventh Circuit said that merely characterizing a claim as facial is insufficient to justify shunting the case into the district court instead of following the statutorily prescribed administrative process.

Getting to the Merits

If the cases disputing the SEC's ALJs can leap the jurisdictional hurdle, the next question is whether the agency's ALJs are inferior officers or employees. The appointments clause in Article II of the U.S. Constitution permits Congress to vest the appointment power in the president alone, heads of departments, or courts of law. Folded into this structure is the tripartite organization of federal government officers into principal officers, inferior officers, and lesser functionaries (*i.e.*, employees), with the upshot being that employees are beyond the reach of Article II.

As the Supreme Court in *Freytag* observed, the ability of those in government to appointment other officials has both structural and political roots in the separation of powers doctrine. To this end, the appointments clause seeks to prevent one branch of government from running roughshod over another, and to avoid the diffusion of the appointment power. The high court also said more generally that legal challenges based on the appointments clause are "neither frivolous nor disingenuous," a sentiment echoed by the district court in the *Bebo* case contesting the legality of the SEC's ALJs. The *Bebo* judge ruled for the SEC on jurisdictional grounds, but still noted that Bebo's claims are "compelling and meritorious."

Appointments Clause Basics

The Appointments clause plays a key role in letting the president do business without overstepping the bounds of his power. The president holds the executive power of the government with the related duty to faithfully execute the laws. But tensions can arise between these goals when it comes to the appointment of various government officers, including inferior officers and employees whose duties may overlap.

Chief Justice Roberts led a bare majority in *Free Enterprise* to the conclusion that multiple layers of good cause removal can violate Article II because they hinder the president's ability to faithfully execute the laws. The court also said many other things, including that the Commission is a "department" under the appointments clause (*i.e.*, a freestanding, non-subordinate executive branch component), and that the full Commission acting collectively is the head of a department. But the court declined to rule on the Commission's status as an "executive department" under Article II's opinion clause or the Twenty-Fifth Amendment.

Yet according to the challengers, the SEC's ALJs exercise vast powers akin to those typically granted to inferior officers. Their complaints recite a laundry list of powers given to ALJs under the Commission's rules of practice. A resolution of the SEC ALJ cases will likely focus on the Supreme Court's *Freytag* opinion (the challengers like it) and the D.C. Circuit's opinion in *Landry* (a bulwark for the SEC).

One of the Supreme Court's sidebars in *Free Enterprise* sheds a bit of light on why this case turns up in almost every argument in the SEC ALJ cases, regardless of which side is making its point. *Free Enterprise* left open the question of how to treat other government employees and "lesser functionaries." In a footnote, the court also said its holding did not deal with ALJs, although the majority noted (with a nod to the D.C. Circuit's *Landry* opinion) that it is "disputed" whether ALJs are officers

of the U.S. The ALJ reference was tacked onto the court's main text statement warning against reading *Free Enterprise* to call into question the federal government's civil service system.

Freytag Finality

The challengers like *Freytag* because of the analogies they see between the SEC's ALJs' powers and those held by the Tax Court's Special Trial Judges (Chief Justice Roberts argued for the Internal Revenue Service in *Freytag* and would go on to author *Free Enterprise*). Congress enacted several Tax Reform Acts in the mid-1980s that enabled the Chief Judge of the U.S. Tax Court to appoint STJs to aid tax court judges in performing their duties. The TRA provision at issue in *Freytag* gave STJs the authority to decide three types of cases involving declaratory judgments and limited dollar amounts, but only the authority to propose findings and opinions in other cases.

The Supreme Court quickly held that the structure and legislative history of the TRA gave the Chief Tax Judge power to assign any other matter not specified by the law to an STJ. This holding rejected the idea that the Chief Tax Judge's general grant must be limited to the smaller enumerated matters in other parts of the law. The court also rejected the argument that the constitutional claims had been waived and instead dealt with the Article II issue.

The court first held that the STJs were inferior officers because of the wide array of powers they possessed, while casting aside the Commissioner's argument in the standing context that in at least the "other" cases category the STJs are merely employees since they lacked finality. "The fact that an inferior officer on occasion performs duties that may be performed by an employee not subject to the Appointments Clause does not transform his status under the Constitution," said the court. Put another way, the three enumerated powers to decide cases given to the STJs also made them inferior officers in the other category where they lacked finality.

Ultimately, the Tax Court was subject to the appointments clause because it is an Article I court established by Congress that exclusively performs judicial functions while exercising a portion of the nation's judicial power. The Tax Court's decisions also can be appealed only to the federal circuit courts or the Supreme Court. Moreover, the court said in a footnote that the existence of a Tax Court rule providing for deferential review of STJ findings had no influence on the justices' decision to hear *Freytag*. This last point did influence the concurrence in the D.C. Circuit's *Landry* opinion, and drew the attention of one of the district judges in the SEC ALJ cases.

The Landry Case

The SEC's favorite precedent is the D.C. Circuit's *Landry* opinion. In *Landry*, the Federal Deposit Insurance Corporation sought to remove a bank executive from his position and to bar him from holding any similar job at an FDIC-insured bank. The FDIC assigned the case to an ALJ who recommended the removal and bar, a decision the bank executive appealed to the FDIC board, which issued a final decision upholding the ALJ's recommendation. The bank executive then petitioned the D.C. Circuit to review the FDIC decision while also raising the appointments clause to argue that the FDIC ALJ was an inferior officer. The FDIC countered that its ALJs were employees beyond Article II.

At the outset of its opinion, the appeals court noted finality's "uncertain" role in *Freytag* along with the Supreme Court's invocation in that case of "a magic phrase" from its *Buckley* opinion ("significant authority") and the high court's "shrug" as it declared the STJs were inferior officers (mostly because of their finality). The *Landry* court also noted the irony of *Freytag*: the Supreme Court found the STJs exercised powers typical of an inferior officer, even if the STJs there did not exercise any final powers in that case.

Still, the D.C. Circuit felt compelled to likewise place great emphasis on the question of whether the FDIC's ALJs had power to make final decisions. They did not. "Accordingly, we believe that the STJs' power of final decision in certain classes of cases was critical to the [Supreme] Court's decision [in *Freytag*]. As the ALJs hired pursuant to s 916 of FIRREA have no such powers, we conclude they are not inferior officers."

But *Landry* did not end with the majority's declaration. Judge Randolph joined the majority's denial of the review petition because there was no prejudice to the bank executive, but he wrote separately to question the majority's attempt to distinguish *Freytag*. The judge said the majority leaned too heavily on *Freytag*'s reliance on the Tax Court's internal rule giving deference to some of the STJs' non-final decisions because the Tax Court could still opt for any review standard.

Judge Randolph also said the majority side-stepped the Supreme Court's "alternative holding" in *Freytag* that the result there would be the same even if the STJs had less significant duties. Moreover, Judge Randolph observed in a footnote that de novo agency review

should not be assumed to diminish the persuasiveness of an ALJ's recommendations on those who review them.

Employees or Inferior Officers?

The district courts in the SEC ALJ cases diverge on the employee versus inferior officer debate. At this stage, the courts are understandably focused on the jurisdictional issue, but most of them have at least spoken in general terms about whether they see the SEC's ALJs more like the STJs in *Freytag*, or the FDIC's ALJs in *Landry*. But the *Charles Hill* case bears special mention because Judge Leigh Martin May's opinion provides the most comprehensive discussion yet of the issue.

Judge May took up the question in the context of her decision to preliminarily enjoin the SEC's administrative proceeding against Hill. She found the similarities between the "significant authority" exercised by the *Freytag* STJs and the SEC's ALJs compelling. The test she cited comes from the Supreme Court's *Buckley v. Valeo* decision (famous for other reasons) in which the court said an appointee who exercises "significant authority" is an officer of the U.S. Judge May also invoked the "alternative" holding theory in the *Landry* concurrence as evidence that finality was not the only touchstone in *Freytag*, and the notion that agency deference to an ALJ's findings had a limited role in *Freytag*.

The government continues to argue to federal courts that the SEC's ALJs are employees, and not inferior officers. The Commission's own public remarks on the issue can be found in its opinions in the *Raymond J. Lucia Companies* and *Timbervest* administrative proceedings. Specifically, the Commission in *Timbervest* noted that the Supreme Court shied away from deciding issues about ALJs in *Free Enterprise*. The Commission also noted that its ALJs lack finality and have different duties than the PCAOB board members in *Free Enterprise*. A dissent by Commissioners Gallagher and Piwowar in *Raymond J. Lucia Companies* has not yet been publicly released.

Claims of ALJ bias

The challengers also claim that the SEC's ALJs routinely favor the agency's enforcement division in administrative proceedings. The bias claim has its roots in a *New York Times* story that raised the question of a general bias in favor of the SEC because of the loose rules and compressed time frame typical of administrative proceedings. The more specific claims about tipping the balance for the enforcement division comes from a recent *The Wall Street Journal* story that recited allegations by an ex-SEC ALJ of pressure from the Chief ALJ to rule for the enforcement division.

The SEC took the claims seriously enough to *order* additional briefing on them in the *Timbervest* matter. Previously, the Commission had *invited* ALJ Elliot to provide an affidavit in *Timbervest* stating his views on the bias question. The agency's inspector general also took the claims seriously and began an investigation that so far has produced an *interim report* finding no evidence of ALJ bias. The OIG's interim report also noted that ALJ Elliot cited "multiple reasons" for declining to respond to the Commission's invitation.

The Commission briefly spoke on the bias issue in *Timbervest*. The Commission reiterated that its ALJs are presumed unbiased absent a showing that their behavior clearly demonstrated an inability to fairly judge a matter. The Commission rejected Timbervest's claim that ALJ Elliot's findings in the matter showed bias. The opinion even pointed out a few of the ALJ's findings that helped Timbervest.

Moreover, the Commission said two *The Wall Street Journal* stories would be part of the record in *Timbervest*, but the Commission found their suggestions of ALJ bias unconvincing. One story accused ALJ Elliot of bias for the enforcement division, which the Commission said was not present in the *Timbervest* record. The Commission also said the other story's allegations about former ALJs was unconnected to *Timbervest*.

An Elegant Remedy?

As detailed in the complaints and especially Judge May's *Gray* and *Charles Hill* opinions, the SEC's ALJs often are not appointed by the Commission but instead are hired by the agency through its Office of Administrative Law Judges. The hiring process is done in consultation with the OPM, the SEC's chief ALJ, and the agency's human resources staff. ALJ salaries are governed by federal laws applicable to the civil service. Given these realities, is there anything the SEC can do to fix the problem on its own?

Judge May's Solution

In *Charles Hill* and *Gray*, Judge May suggested the Commission might cure its Article II problem by simply appointing its own ALJs or by presiding over its administrative matters. The judge cited *Free Enterprise* for the Supreme Court's view that, at least in the context of that case, the SEC's commissioners acting together are the head of a department. Judge May also noted that the SEC had conceded that at least one of its ALJs (James Grimes) was not appointed by the commissioners.

Judge Berman's *Duka* decisions have evolved from his earlier *jurisdictional order* denying Barbara Duka's request to halt the SEC's proceeding against her to his change of mind that later resulted in a preliminary injunction against the SEC. Judge Berman's reversal was prompted by Duka's amended complaint, which added the appointments clause claim.

Judge Berman was intrigued enough by Judge May's proposed solution that he issued a pair of orders *designed* to give the SEC time to *cure* its Article II predicament. He noted an affidavit by the SEC's Deputy COO in the *Timbervest* administrative proceeding that suggested ALJ Cameron Elliot was not appointed by the SEC's commissioners. In the first order, Judge Berman noted the SEC may be mulling its options to fix the Article II issue and he gave the agency seven days to confirm that it would cure the problem. A week later, Judge Berman stopped the agency's proceeding against Duka.

A recent opinion by the Federal Trade Commission demonstrates how sensitive government agencies are to questions about the validity of their ALJs. The FTC's opinion also shows a growing interest in Judge May's proposed solution. According to the FTC's LabMD *opinion*, the agency's ALJs are not inferior officers, but "purely as a matter of discretion" the FTC opted to ratify the appointment of an ALJ as both its chief ALJ and as the presiding ALJ in the administrative proceeding.

While it may be possible for a court to fashion an elegant remedy in the SEC ALJ cases, the Supreme Court did that in *Free Enterprise*. Upon finding the PCOAB's structure unconstitutional, the court also found the offending tenure provision was severable from SOX. That meant the Commission could remove PCAOB board members at will without trampling the president's ability to faithfully execute the laws because now there would be just one level of good cause removal. That also meant SOX remained in full force.

Is the ALJ Remedy That Easy?

Justice Breyer's *Free Enterprise* dissent accused the majority of leaving too many open questions about its dual for cause holding, including whether it applied to ALJs across the federal agencies. He said the majority was "wrong—very wrong" because its rule must be read by future courts to apply only to the PCAOB, or it must sweep widely to cover other inferior officers with the potential for the court's case-by-case approach to subvert the president's constitutional authority while possibly disrupting the administrative functions of the federal government.

For one, Justice Breyer questioned how *Free Enterprise* might be interpreted by a future Supreme Court. He explained that while the majority tried to dodge the issue of inferior officers who perform adjudicatory duties, the PCAOB board members who were the subject of that case did perform some adjudicatory tasks. The justice also mulled whether the exclusion of ALJs from *Free Enterprise*'s holding would hold up if an ALJ had administrative duties beyond his adjudicatory ones. And Justice Breyer wondered if the majority's seeming attempt not to extend its holding to the civil service would also apply to the subset of civil officers who are part of the government's competitive service.

Moreover, Justice Breyer said *Free Enterprise*'s severability solution has its limits because the court's ability to excise a law's constitutionally infirm text depends on the court's understanding of the Congressional intent in drafting the law. Likewise, Justice Breyer questioned if more would be needed to fix the still open questions about not just ALJs, but also the military. Specifically, he posed a string of questions: Must officials stop their work while courts decide their fate? Does Congress need to fix for cause removal laws? And can the president resolve these issues via executive order?

What's Next?

The next months will likely see more federal court appeals and more ALJ and Commission action as the administrative cases that have not been halted by the courts move forward. It is possible that the Commission's opinions in *Raymond J. Lucia Companies* or *Timbervest* could result in a petition for federal appellate review. There is also a larger question of what might be the impact if a circuit split developed among the appellate panels in the SEC ALJ cases? Yet another question is whether one or more decisions against the SEC could have a contagion effect on ALJs across federal agencies, a point Justice Breyer spoke to in his *Free Enterprise* dissent.

The Appeals Courts

The Second Circuit heard oral arguments in *Tilton* in mid-September, and briefing is ongoing in the Eleventh Circuit and other Second Circuit cases. The fact-specific scenarios in the four Supreme Court analogs can be read to support either the challengers or the SEC. It is one thing for the

district courts to reach conflicting results, but what are the challengers' and the SEC's prospects in the three appellate courts that have or will take up the ALJ issue?

As mentioned, the Seventh Circuit in *Bebo* upheld a district court's dismissal of a case disputing the validity of the SEC's enforcement regime because it was fairly discernable that Congress intended the claims raised to be channeled through the administrative process. This decision has been criticized by some of the challengers in the other federal appeals.

For example, in Hill's suit against the SEC, Hill argued in a *brief* to the Eleventh Circuit that *Bebo* misread *Free Enterprise* as being narrowly limited to its specific facts. Hill also argued that a future decision by the Eleventh Circuit following the Seventh Circuit may incite a spate of new pre-enforcement suits which the SEC would try to side-step by asserting ripeness issues.

Moreover, Hill explained that only outsiders to agency matters could bring claims like his if the Eleventh Circuit were to follow *Bebo*. "If *Free Enterprise's* holding is as narrow as the SEC and the *Bebo* panel believe, it produces an ironic result. Under that view, the only litigant who could challenge the constitutionality of the SEC's in-house proceeding is someone who is outside of it."

But the Eleventh Circuit itself may have already answered the channeling question. Just this year, the court said in *LabMD* that the more the federal court claims are "intertwined" with those in an administrative proceeding, the more likely the claims must be channeled through the agency first. The circuit's decade-old *Doe v. FAA* opinion also had reiterated that claims must go to an agency first if that was the Congressional intent. But the district judge in the *Charles Hill* case found *Doe* distinguishable because Hill's claim about the SEC proceeding was independent of the SEC's substantive allegations or the agency's conduct in the proceeding.

As for the Second Circuit, its decision three years ago in *Altman v. SEC* strongly implies a general circuit rule that a respondent challenging an agency administrative proceeding may not skip the administrative process in favor of bringing a case in a federal district court. The district judge in *Tilton* made exactly this point in his discussion of the Supreme Court's analogs.

Government Disruption?

Once again, Justice Breyer's *Free Enterprise* dissent offers a glimpse of how the government's administrative functions may be impacted by a court ruling against the existing use of ALJs by the SEC or other government agencies. In four appendices to his dissent, the justice noted 48 agency heads subject to for cause removal and 573 senior government officials subject to for cause removal. Justice Breyer also found 28 federal agencies using more than 1,500 ALJs.

Justice Breyer's data was last updated for *Free Enterprise* in June 2010 when the court issued its opinion in the case, but some of the data cited was compiled by Congressional committees and the OPM in the mid-2000s. At that time, the SEC had four ALJs, and the CFTC had two. The Social Security Administration was the leader by far with 1,334 ALJs, although six other agencies had ALJs numbering from 11 to 65. Justice Breyer characterized these ALJs as inferior officers (a key question in the ongoing SEC ALJ cases) while noting that all of them enjoy dual for cause removal by law. The implication of Justice Breyer's data-driven dissent is that a court decision upsetting the existing use of ALJs could disrupt federal agencies' business.

Conclusion

Given the questions left open by *Free Enterprise*, the SEC ALJ cases would seem to be a perfect example of claims that may end up being decided by the Supreme Court. That said, there is no guarantee that a circuit split, one touchstone for the high court taking a case, will ever develop in the ALJ suits, and the Supreme Court might still deny certiorari. Moreover, the government, the SEC, and the challengers could delay an eventual appeal to the Supreme Court for months while panel and en banc rehearing petitions are ruled on by the circuit courts. The decision to take on the SEC over its ALJs remains a highly individual one for the respondents, but it is clear that a small number of motivated SEC enforcement targets appear willing to see the matter to its constitutional end.

Appendix A—SEC Administrative Proceedings

Respondent	OIP	Significant Orders	Initial Decision	Commission Opinion	Federal Appeals Court Petition
In Re Raymond J. Lucia Companies	34-67781		ID-540	34-75837	
In Re Timbervest	IA-3678	Supplemental briefs on ALJ issues IA-4003 1/20/2015	ID-658	IA-4197 IA-4198 Oral argument held 6/8/2015	
In Re Peixoto	34-73263	Dismissed 34-74176 1/29/2015			
In Re Bebo	34-73722	Co-respondent settled 34-74177 1/29/2015			
In Re Duka	33-9706				
In re Spring Hill	34-74119				
In Re Charles	34-74249				
In re Stilwell	IA-4049				
In Re Tilton	IA-4053	Stay pending 2d Cir ruling denied 9/1/2015			
In Re Gray Financial	33-9789				
In Re Ironridge	34-75272				

Appendix B—Federal Court Proceedings

Case	Complaint	Case No.	Judge	Opinions	Notice of Appeal	Court of Appeals	Opinion
Stillwell v. SEC	10/1/2014	SDNY 14cv7931	Katherine B. Forrest	Voluntary dismissal 3/16/2015			
Peixoto v. SEC	10/20/2014	SDNY 14cv8364	William H. Pauley, III	Voluntary dismissal 1/30/2015			
Bebo v. SEC	1/2/2015	ED Wis 15cv3	Rudolph T. Randa	3/3/2015	Bebo 3/10/2015	7th Cir 15-1511	8/24/2015
Duka v. SEC	1/16/2015 Amended 6/10/2015	SDNY 15cv357	Richard M. Berman	4/15/2015 8/3/2015 8/12/2015	SEC 8/26/2015	2d Cir 15-2732	
Gray Financial v. SEC	2/19/2015 Amended 3/31/2015 6/3/2015	ND Ga 15cv492	Leigh Martin May	8/4/2015	SEC 8/19/2015	11th Cir 15-13738	
Tilton v. SEC	4/1/2015	SDNY 15cv2472	Ronnie Abrams	6/30/2015	Tilton 7/1/2015	2d Cir 15-2103	Oral Argument 9/16/2015 Stayed 9/17/2015
Charles Hill v. SEC	5/19/2015 Amended 5/29/2015	ND Ga 15cv1801	Leigh Martin May	6/8/2015 SEC stay denied 8/4/2015	SEC 6/24/2015	11th Cir 15-12831	
Spring Hill v. SEC	6/11/2015	SDNY 15cv4542	Edgardo Ramos	Dismissed 6/29/2015			
Timbervest v. SEC	6/12/2015	ND GA 15cv2106	Leigh Martin May	Stayed 8/19/2015			
Ironridge v. SEC	7/14/2015	ND Ga 15cv2512	Leigh Martin May				