Second Circuit Holds that the Federal Courts Lack Jurisdiction to Hear Attacks Against Ongoing SEC Administrative Proceedings

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On June 1, 2016, the United States Court of Appeals for the Second Circuit held that federal courts do not have jurisdiction to hear constitutional challenges to *ongoing* Securities and Exchange Commission (the "SEC") administrative proceedings.[1] The Second Circuit's decision in *Tilton v. SEC* marks the third appellate court to reject constitutional challenges to SEC administrative proceedings for jurisdictional reasons. Although federal courts, and possibly the Supreme Court, will ultimately decide these questions after the conclusion of SEC administrative proceedings, the Second Circuit's decision precludes securities defendants from immediately challenging SEC proceedings in federal court.

Lynn Tilton's Federal Lawsuit Against the SEC.

In *Tilton v. SEC*, the SEC initially filed an administrative proceeding against Lynn Tilton and certain investment firms (collectively, "Tilton"), seeking penalties under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* Soon after the SEC filed the administrative proceeding, Tilton sued the SEC in a federal court in New York, raising constitutional challenges to the administrative proceedings. Among other arguments, Tilton contended that the SEC administrative law judges' ("ALJs") appointment violated the constitution because ALJs are "inferior Officers" who are not appointed by the SEC Commissioners, the President, or a court as required by Article II of the constitution (the "Appointments Clause"). Tilton sought an injunction in federal court to stay the SEC's administrative proceedings.

The district court (Abrams, J.) held that it did not have jurisdiction to hear the challenge because Tilton filed the lawsuit before the administrative proceeding concluded. Tilton appealed to the Second Circuit, and the Second Circuit stayed the SEC proceedings against Tilton while it decided the appeal.

The Second Circuit Holds that Tilton May Not Immediately Seek Federal Review.

A divided Second Circuit affirmed the district court's conclusion that Tilton must wait until after the SEC proceedings conclude before bringing a constitutional challenge in federal court. The majority opinion reasoned that Congress intended the SEC's structure of administrative and judicial review to preclude district court jurisdiction and that Tilton's Appointments Clause challenge should first be decided by the SEC.

The court explained that the SEC's statutory structure guaranteed Tilton's constitutional arguments meaningful judicial review following the administrative proceeding's conclusion. That Tilton must first complete the entire administrative proceeding (and suffer monetary and reputational costs) before

[1] *Tilton v. SEC*, No. 15-2103 (2d Cir. June 1, 2016).

obtaining federal review did not make that review any less meaningful. Instead, the majority explained that those costs are "simply the price of participating in the American legal system, and not an irreparable injury."[2]

Nor was Tilton's Appointments Clause challenge "wholly collateral" to the administrative proceeding. Because Tilton raised the challenge as an affirmative defense, the court reasoned that the challenge was "procedurally intertwined" with the SEC proceeding.[3] And although a "close question," the court held that Tilton's constitutional challenge did not fall outside the SEC's expertise because the SEC might resolve other statutory issues that would fully dispose of the proceeding in Tilton's favor, thus mooting the constitutional questions.

In a dissenting opinion, Judge Droney contended that the majority's reasoning, which focused on Tilton's ability to make the constitutional challenge as an affirmative defense, proved too much because under that rationale no claim could be "wholly collateral" "as long as the claim could somehow serve to end administrative proceedings in a [securities defendant's] favor."[4] The dissent similarly criticized the majority's interpretation of the "outside of the agency's expertise" factor. If that factor is not met where, as the majority held, the SEC could decide other issues that would resolve the proceeding in the defendant's favor, then "as long as a proceeding is ongoing . . . [that] factor *must* weigh against jurisdiction—because any time a proceeding has commenced there is of course some possibility that a plaintiff may prevail on the merits."[5] Judge Droney also emphasized that forcing defendants to withstand an administrative proceeding before bringing a federal constitutional challenge undercuts meaningful judicial review because "they will already have suffered the injury that they are attempting to prevent."[6]

The Second Circuit's Decision Will Not Prevent Federal Courts from Eventually Deciding the Constitutional Issues.

In the short term, the Second Circuit's rule adds pressure on securities defendants to settle administrative proceedings rather than fully litigate and subsequently seek federal review of their constitutional challenges. With three circuit courts (the Second, Seventh, and D.C. Circuits) agreeing on the jurisdictional question, the likelihood that the Supreme Court will take up this issue is low.[7] That may change, however, if the Eleventh Circuit (which heard argument on the same jurisdictional issue in February 2016) decides the question differently.

Notwithstanding the Second Circuit's ruling, federal courts eventually will answer these constitutional questions. The D.C. Circuit, for instance, will soon decide a fully ripe challenge to SEC proceedings' constitutionality.[8] Accordingly, although the *Tilton* case represents a win for the SEC and agency administrative proceedings more generally, it may be overshadowed by forthcoming federal court decisions addressing whether SEC ALJs have been constitutionally appointed.

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[2] *Tilton*, No. 15-2103, Slip Op. at 22.

[3] *Id.* at 28.

[4] *Id.* at 11 (Droney, J., dissenting).

[5] *Id.* at 14.

[6] *Id.* at 20.

[7] In March 2016, the Supreme Court declined to take up this issue in an appeal from the Seventh Circuit's ruling in *Bebo v. SEC*, 136 S. Ct. 1500 (2016).

[8] *Lucia v. SEC*, No. 15-1345 (D.C. Cir.) (oral argument held May 13, 2016).

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