

April 18, 2023

# Supreme Court Holds That District Courts May Hear Challenges to Constitutionality of SEC and FTC Administrative Proceedings

On April 14, 2023, the U.S. Supreme Court held in *Axon Enterprise Inc. v. FTC* (and its companion case, *SEC v. Cochran*) that district courts retain federal-question jurisdiction over challenges to the constitutionality of SEC and FTC administrative proceedings. The decision may further incentivize the SEC and FTC to file contested enforcement actions in federal court to avoid these constitutional challenges.

## Background

While the SEC and its staff may enforce the federal securities laws by filing a complaint in federal district court, the SEC may also pursue an administrative proceeding before one of its administrative law judges (“ALJs”). In 2016, the SEC brought an administrative enforcement action against certified public accountant Michelle Cochran, alleging that she failed to comply with auditing standards in violation of the Exchange Act. After an ALJ found that Cochran had violated the Exchange Act, she objected to the decision. In light of an intervening change in law with respect to the manner in which ALJs were appointed, the SEC subsequently remanded all pending administrative proceedings, including Cochran’s, to start anew.

Cochran then filed suit in federal district court, seeking to enjoin the remanded administrative proceeding against her. Cochran argued that SEC ALJs are unconstitutionally insulated from the President’s removal power, because the President is not empowered to remove ALJs directly. Instead, they enjoy two layers of tenure protection: ALJs can be removed only for good cause as determined by the Merit Systems Protection Board (“MSPB”) and MSPB officials are removable by the President only for inefficiency, neglect of duty, or malfeasance.

Section 78y of the Exchange Act states that parties to an administrative proceeding before an SEC ALJ may seek judicial review of that proceeding once the Commission renders a final order, by filing a petition for review in the appropriate court of appeals. Accordingly, in the face of this challenge, the district court dismissed the case for lack of jurisdiction, concluding that Section 78y implicitly stripped district courts of jurisdiction to hear a challenge to an ongoing SEC enforcement proceeding. The district court held that all challenges to an SEC proceeding must be brought in the relevant court of appeals after the administrative proceeding has concluded.

A divided panel of the Fifth Circuit affirmed, holding that Section 78y precluded review of SEC proceedings in district courts because it authorized review of final SEC orders in courts of appeals. Moreover, the majority concluded that Cochran’s removal-power claims were not exempt from this jurisdictional bar. Judge Haynes dissented in part on the ground that Cochran’s removal-power claims were “not the type over which Congress intended to limit jurisdiction.” After the Fifth Circuit granted

rehearing en banc, the en banc court reversed by a vote of 9-7, holding that the district court had federal question jurisdiction under 28 U.S.C. § 1331 to hear Cochran's removal-power claim, and that Section 78y did not strip district courts of jurisdiction to hear structural constitutional challenges.

Similar to Cochran's constitutional challenge against the SEC, Axon Enterprise filed suit in district court arguing that a pending FTC administrative enforcement proceeding was unconstitutional because the ALJ was similarly unconstitutionally insulated from the President's removal power. Axon further argued that FTC enforcement actions violate due process because the agency both prosecutes and adjudicates them. After the district court dismissed Axon's challenge for lack of jurisdiction under a similar provision in the Federal Trade Commission Act, a divided panel of the Ninth Circuit affirmed dismissal. The panel reasoned that Axon would have meaningful judicial review of its constitutional claims because the Supreme Court held in *Thunder Basin* that such claims "can be meaningfully addressed in the Court of Appeals," even though the petitioner there similarly argued that the agency process itself would violate its constitutional rights."

The Supreme Court granted review to decide whether a federal district court has jurisdiction to hear a suit in which the respondent in an ongoing SEC or FTC administrative proceeding seeks to enjoin that proceeding, based on an alleged constitutional defect in the statutory provisions that govern the removal of the ALJ who will conduct the proceeding.

### The Supreme Court's Decision

In an opinion written by Justice Kagan, the Court held that the statutory review schemes set out in the Securities Exchange Act and the Federal Trade Commission Act did not divest district courts of jurisdiction to hear Cochran and Axon's constitutional challenges to the agencies' fundamental structure. The "ultimate question" before the Court, Justice Kagan wrote, "is how best to understand what Congress has done—whether the statutory review scheme, though exclusive where it applies, reaches the claim in question." To answer this question, the Court considered three factors first announced in *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994): (1) whether precluding district court jurisdiction would "foreclose all meaningful judicial review" of the claim; (2) whether the claim is "wholly collateral to [the] statute's review provisions"; and (3) whether the claim is "outside the agency's expertise." Because all three factors set forth in *Thunder Basin* cut against the agencies, the Court concluded that these claims were not "of the type" that Congress intended to subject to these review schemes.

First, the Court reasoned that precluding district court jurisdiction of these constitutional challenges would threaten to foreclose all meaningful judicial review of these sorts of claims. For example, although Cochran could ultimately seek appellate review of an adverse administrative action under the Securities Exchange Act's statutory scheme, Cochran's alleged injury is being forced to participate in an unconstitutional proceeding. That injury, according to the Court, was not one that an appellate court can remedy by subsequently reviewing the ALJ's decision.

Second, the Court opined that these constitutional claims were "wholly collateral" to the statutes' review provisions. Cochran and Axon each challenged the SEC and FTC's respective powers to hold an adjudicatory proceeding as a general matter, and not any actions the respective agencies took in such a proceeding.

Third, Cochran and Axon's claims were "outside of the agency's expertise." The Court reasoned that separation-of-powers challenges raise questions of administrative and constitutional law "detached" from agency expertise, and that Axon's challenge to the FTC's combination of prosecutorial and adjudicative functions was similarly "distant" from the Commission's "competence and expertise."

In a concurrence, Justice Thomas expressed doubt that Congress may vest administrative agencies with primary authority to adjudicate "core private rights" to life, liberty, and property. Justice Thomas wrote that Congress might violate the separation of powers by compelling the judiciary branch to defer to the executive branch on matters that the Constitution vests in the judiciary. Justice Thomas also opined that Congress might violate due process by empowering agencies to deprive citizens of core private rights, because such agencies are not courts of competent jurisdiction. He further noted that "the appellate review model" might violate the Seventh Amendment because agencies adjudicate "what may be core private rights without a jury."

Justice Gorsuch concurred only in the judgment and expressed his disagreement with the *Thunder Basin* balancing test as an incoherent “judge-made” device. In his view, the Court need only review the relevant statutory text to assess whether Congress “has actually carved out some exception” to jurisdiction and that Section 1331 grants district courts the ability to hear the constitutional claims here.

### Implications

The Court’s decision is limited to whether district courts have jurisdiction to hear fundamental constitutional challenges to the structure of the SEC and FTC. The Court did not reach the merits of such claims. Going forward, we may see additional parties subject to administrative actions choose to initiate constitutional challenges in district courts in certain circumstances. This could have the effect of slowing the pace of related SEC and FTC administrative proceedings. Ultimately, courts will rule on these challenges and the Supreme Court will have occasion to weigh in on the constitutionality of the agencies’ administrative proceedings practices.

In the near term, it is likely that the SEC and FTC will favor initiating actions in district courts rather than administrative proceedings in an attempt to avoid potential constitutional problems arising out of the administrative framework. SEC proceedings that take place in federal district court are often more formal and time-consuming, given that the Federal Rules of Civil Procedure apply. By contrast, FTC actions in federal court are not necessarily longer than administrative proceedings (and may indeed be resolved more quickly).

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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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