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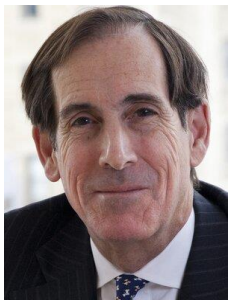
Where Kavanaugh May Land On SEC In-House Court Issue

By **Evan Stewart** (December 12, 2022, 4:52 PM EST)



Evan Stewart

Predicting how U.S. Supreme Court Justices will vote on a pending case may well be a fool's errand.

But here goes: How might Justice Brett Kavanaugh view the pending challenges to in-house agency judicial proceedings in U.S. Securities and Exchange Commission v. Cochran[1] and Axon Enterprise Inc. v. Federal Trade Commission?[2]

Well, not only did Justice Kavanaugh join with the recent majority decision in West Virginia v. U.S. Environmental Protection Agency[3] — where the court struck down the EPA's far-reaching fossil-fuel regulations as delegated "power beyond what Congress could reasonably be understood to have granted" — but a dissenting opinion he wrote as a judge of the U.S. Court of Appeals for the District of Columbia Circuit in Lorenzo v. SEC also gives us a pretty darn good predictor of Justice Kavanaugh's views of the SEC's in-house judicial procedures.

Lorenzo

In 2019 in Lorenzo v. SEC, the Supreme Court sidestepped three of its prior precedents — and numerous lower court decisions following those precedents — to find primary liability under Rule 10b-5 via the scheme liability provision of Rules 10b-5(a) and 10b-5(c).[4]

Now, no longer would only makers of misrepresentations be primarily liable, but also disseminators of misrepresentations would be as well.[5]

Importantly, the factual underpinnings of that case made the court's dramatic rejection of its prior precedents possible. In the in-house SEC proceeding, the SEC administrative law judge opined that Lorenzo's "falsity" had been "staggering" and that his mental state had been at least "reckless." The full commission did not evaluate the factual record developed at trial in affirming the ALJ's decision, and neither did the two-member panel of the D.C. Circuit that also found Lorenzo on the wrong side of Rule 10b-5 in 2017.

As foreshadowed above, the dissenting vote on the D.C. panel came from then-Judge Kavanaugh. He first noted that the factual record and the ALJ's determinations did not "square up":

At most, the judge's factual findings may have shown some mild negligence on Lorenzo's part ... [I]t is impossible to find that Lorenzo acted "willfully."

Thus, according to Justice Kavanaugh, the ALJ's decision violated "basic due process ... [because] mens rea is essential to preserving individual liberty." Justice Kavanaugh then opined that the commission had "simply swept the judge's factual and credibility findings under the rug" in its rush to judgment.

In his view, the D.C. Circuit panel should not have given deference to the SEC, but should instead have looked de novo at the record developed before the ALJ in assessing whether Lorenzo had in fact willfully engaged in a scheme to defraud. Of course, the majority of the panel did not do so, and neither did the Supreme Court in its determination to expand Rule 10b-5 liability.

Justice Kavanaugh recused himself from Lorenzo when it was before the Supreme Court.

Jarkesy

A recent article in Law360[6] posited that Justice Kavanaugh might well ally himself with the SEC in SEC v. Cochran.[7] The article's positing related to an SEC in-house enforcement case begun in 2013 against George R. Jarkesy Jr. and his investment advisory firm, Patriot28LLC.

The respondents were charged with inflating the valuation of two hedge funds in order to increase the fees they received. An in-house SEC ALJ found them liable and ordered (1) Jarkesy barred from the securities industry, (2) Jarkesy and Patriot28 to pay a $300,00 civil penalty, and (3) Patriot28 to disgorge approximately $685,000 plus interest. Those determinations were affirmed by the commission itself, but the respondents thereafter sought to overturn them in the U.S. Court of Appeals for the Fifth Circuit.

In its May 18 decision, a Fifth Circuit panel — by 2-to-1 — vacated the SEC's decision. Although the Dodd–Frank Wall Street Reform and Consumer Protection Act allows the commission to bring securities fraud actions for money damages either before an in-house ALJ without a jury or before an Article III judge in federal court, the court of appeals found the SEC's in-house proceeding violated the Constitution for three reasons:

- First, that denying Jarkesy his Seventh Amendment right to a jury trial was unconstitutional;
- Second, that Congress' authorizing the SEC to elect in which forum to proceed without any guidance was an unconstitutional delegation; and
- Third, that the SEC's ALJs are unconstitutionally insulated from presidential oversight in violation of the Constitution's take care clause.

On July 1, the SEC asked the Fifth Circuit to review the decision en banc. On Oct. 22, the court of appeals — undoubtedly well aware of Cochran and Axon — denied that petition.

What the Law360 article highlighted was the fact that in 2015 Judge Kavanaugh joined in an opinion written by Judge Sri Srinivasan of the D.C. Circuit, rejecting Jarkesy's attempt to shut down the SEC in-house process because of, inter alia, the constitutional infirmities ultimately ruled on by the Fifth Circuit — and the last of which is before the Court in Cochran.

The Law360 article correctly noted that Judge Srinivasan's holding is in conflict with the Fifth Circuit's

decision in Cochran, which permitted that district court challenge to the in-house proceeding before it was final. Thus, there is a conflict of circuit court rulings on this procedural issue.

Predicting the Future

So, which is the better predictor of how Justice Kavanaugh will cast his vote on Cochran: his views in 2017, or Judge Srinivasan's views — in which then-Judge Kavanaugh joined — in 2015? Put another way, is the procedural issue found determinative by Judge Srinivasan likely to trump the substantive infirmities identified by Kavanaugh?

Oral argument in Cochran and Axon took place on Nov. 7. And contemporaneous reports of the argument suggest that the constitutional questions, issues and problems plaguing agency in-house judicial proceedings may well trump concerns regarding nonfinal judicial challenges to such proceedings.

As for Justice Kavanaugh, his obvious unhappiness with the way the SEC's in-house processes worked in Lorenzo on top of West Virginia v. EPA does not suggest to this observer that he is a likely ally of the SEC or the FTC in the pending cases before the court.

And while I do not claim to be Carnac the Magnificent, it is hard for me to believe that Justice Kavanaugh will forget his dissent in Lorenzo or feel bound by what Judge Srinivasan wrote in Jarkesy.

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[1] SEC v. Cochran https://www.lexisnexis.com/community/case-opinion/b/case/posts/sec-v-cochran.

[2] Axon Enterprise v. FTC https://www.lexisnexis.com/community/case-opinion/b/case/posts/axon-enter-v-ftc-2004417860.

[3] West Virginia v. EPA https://www.lexisnexis.com/community/casebrief/p/casebrief-west-virginia-v-epa.

[4] Lorenzo v. SEC https://www.lexisnexis.com/community/case-opinion/b/case/posts/lorenzo-v-sec.

[5] Lawyer Liability: In the Crosshairs, Again! (Summer 2020) https://www.cohengresser.com/app/uploads/2020/10/Stewart-reprint-BusLawJournal-Summer2020.pdf.

[6] Kavanaugh May Prove Unlikely SEC Ally In Accountant's Case (November 4, 2022) https://www.law360.com/articles/1545708/kavanaugh-may-prove-unlikely-sec-ally-in-accountant-s-case.

[7] Jarkesy v. SEC https://www.lexisnexis.com/community/casebrief/p/casebrief-jarkesy-v-sec.