

Securities Regulation Daily Wrap Up, TOP STORY—7th Cir.: Laurie Bebo takes ALJ case to appeals panel, (Jun. 5, 2015)

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By Mark S. Nelson, J.D.

For the first time, one of the six federal law suits filed in the last year challenging the SEC's administrative law judge (ALJ) regime has made its way on an expedited basis to the Seventh Circuit. A three judge panel led by Judge Ilana Rovner queried Laurie A. Bebo's counsel and the SEC's lawyer about whether a district court could hear the matter. Meanwhile, the drama over the SEC's ALJs continues to play out, sometimes in unexpected ways, in federal courts across the country and before the Commission (*Bebo v. SEC*, audio recording of oral argument, June 4, 2015).

Review now, later, or ever? Bebo, the former CEO of Assisted Living Concepts, Inc. (ALC), had been charged by the SEC last December. The SEC alleged that Bebo violated the Exchange Act's antifraud, record-keeping, and internal controls provisions. John Buono, ALC's ex-CFO, senior vice president, and treasurer, settled the SEC's case against him.

U.S. District Judge Rudolph T. Randa said in his March opinion dismissing Bebo's case that she had raised a constitutional issue that is "compelling and meritorious," but he concluded the federal district court was the wrong place for her to start looking for an answer. According to Judge Randa, Bebo could raise her constitutional claims before the SEC's ALJ and then appeal an adverse final Commission order to a federal appeals court, as provided by the securities laws.

Bebo's brief to the appeals court emphasized that her case is about whether the SEC can invoke its Dodd-Frank Act powers to impose civil penalties on unregulated persons. She relied on the Supreme Court's *Free Enterprise*, *McNary*, and *Thunder Basin* opinions in arguing that a federal district court can hear a challenge to the SEC's administrative regime (as opposed to the merits of the SEC's proceeding). Bebo's reply brief reiterated these points.

Judge Rovner immediately asked Bebo's lawyer, Kate E. Maternowski, if Bebo's case was different from *Free Enterprise* and *McNary* because here there is a pending administrative proceeding. Bebo could still appeal an adverse Commission order, even if the commissioners did not reach Bebo's constitutional claims, said the judge.

Maternowski replied that the Supreme court has not said an administrative case would necessarily bar access to the federal courts. She repeatedly emphasized that the type of case mattered in this context—Bebo, she said, disputes the SEC's forum selection authority, not the law Bebo is accused of violating. In essence, Bebo wants a return to the status quo prior to the Dodd-Frank Act, where a case like the one the SEC brought against Bebo, an unregulated person, would have to be brought in federal court.

Judge Rovner later followed-up this line of questioning by asking if Bebo's due process and equal protection claims about SEC's forum selection authority may bleed into the merits of the administrative case, which could be reviewed by a federal appeals court. Maternowski said "No." According to Bebo's lawyer, Bebo disputes the law enabling the SEC's administrative case, and that makes this an inappropriate case to allow for federal agency review before federal court review.

Maternowski went on to say that Bebo seeks procedural, not substantive relief. She noted that the Supreme Court's opinions split into two lines of precedent, one where the plaintiff sought a substantive remedy, and others where the plaintiff made procedural claims. Another judge suggested Bebo's appeal was an attempt to walk a very thin line between the Supreme Court's two lines of cases, with the existence of a pending administrative case being a key for Bebo.

Maternowski insisted that Bebo could not get meaningful review if forced to wait out the administrative process because the SEC had already said it lacks authority to declare the Dodd-Frank Act provision at issue unconstitutional. At one point, Maternowski returned to the "type of case" theory citing *Free Enterprise* for

the proposition that claims are barred from federal court only if Congress' discernable intent was for the "type of case" involved to follow the statutorily prescribed route. On rebuttal, another judge would seek to clarify with Maternowski that what Bebo wants is for the court to declare the Dodd-Frank Act law enabling the SEC proceeding unconstitutional and to grant an injunction.

Plenary control of ALJs. The SEC had argued in its brief to Seventh Circuit that the Exchange Act provides for an administrative process, after which Bebo could appeal an adverse final Commission order to the Seventh Circuit or the D.C. Circuit. But the SEC said Bebo cannot stop the administrative process, which is already into its third week of testimony, with more to come later this month.

Citing the Supreme Court's *Thunder Basin* and *Elgin* opinions, the SEC argued that Congress expressed "discernable" intent in favor of the statutory administrative process. And citing two other Supreme Court opinions, the SEC said the initiation of administrative proceedings and the burden of responding to a federal agency's charges cannot amount to irreparable harm or otherwise justify stopping an administrative proceeding.

Moreover, the SEC said *Free Enterprise* and *McNary* were distinguishable from Bebo's case because the plaintiffs there would have had to initiate some action. In *McNary*, the immigrant would have had to surrender for deportation; in *Free Enterprise*, a person subject to the PCAOB's rules would have had to violate one of them in order to invoke federal court jurisdiction. But Bebo can appeal an ALJ ruling to the Commission, and a final Commission order to the U.S. appeals courts.

Judge Rovner asked Stern how Bebo's case was different from the Supreme Court's precedents. Stern said that *Free Enterprise*, in particular, dealt with a closely regulated party, and that Bebo is not like the plaintiff there. Stern also said while the oversight agency in *Free Enterprise* could have been found to be unconstitutional, the SEC's constitutionality is not at stake in Bebo's case. Instead, Bebo challenges the constitutionality of a specific proceeding, which Stern said makes this a "classic" case for the prescribed statutory procedure.

Another exchange between Stern and Judge Rovner explored the possibility of whether the constitutional issues Bebo raised would ever get judicial review. Judge Rovner had posed the question of what result obtains if the Seventh Circuit were to affirm Judge Randa and Bebo went on to win her administrative case? Judge Rovner implied that Bebo would then have no forum for where the constitutional issue could be heard.

Stern replied that there would be no irreparable harm to Bebo, and that the administrative process might actually help to avoid the constitutional claims. Stern found support in the Supreme Court's *Standard Oil* opinion and the Seventh Circuit's *R.R. Donnelly* case, dealing with the Administrative Procedure Act's definition of final agency action, and with issues inherent to collateral orders and the role of collateral estoppel.

At the close of Stern's argument, one of the panel judges asked him if an SEC ALJ could act without Commission authority. The judge noted that in *Free Enterprise* there seemed to be at least some functions that the PCAOB could do without getting Commission approval. Stern said he could not think of anything the SEC's ALJs could do without the Commission's approval. Stern emphasized that the Commission has plenary control of its ALJs such that the Commission can either hear a matter itself, or it can delegate to an ALJ.

Younger abstention by analogy. Near the end of Maternowski's argument for Bebo, one of the judges asked about *Younger* abstention. *Younger* espouses the doctrine barring federal courts from interfering with pending state criminal or quasi-criminal proceedings and some state court orders. The judge noted that there were parallels (minus the federalism aspect of *Younger*) between Bebo's case and *Younger*, even if *Younger* would not directly apply.

Maternowski replied that the SEC's administrative proceeding would not stop unless Bebo can show a federal court that the law enabling the SEC's proceeding against her is unconstitutional. She emphasized that Bebo seeks procedural relief, not structural relief. Maternowski also noted that Bebo had not briefed the *Younger* question (in fact, neither Bebo nor the SEC cited *Younger* in their briefs).

The same judge would return to the *Younger* theory in questions to the SEC's lawyer. The judge again noted that a bad procedure can be harmful, even if the party harmed later wins their case. But he also noted that the Supreme Court has said in the criminal setting that the criminal trial is itself due process, while also repeating

his theory that *Younger* is only similar to Bebo's case. Stern answered that *Younger* is "analogous," but said that opinion exists because of the federalism concerns in those cases, whereas Bebo's case arises in the context of a federal agency administrative proceeding.

Judge Rovner not recused. Adding to the drama over the constitutionality of the SEC's ALJs, Judge Rovner disclosed that one of her career law clerks is the sister of one of Bebo's lawyers, Mark A. Cameli. Judge Rovner began the oral argument by making "full disclosure" of this potential conflict, but she said she did not believe she needed to recuse herself because the clerk had been "walled-off" from any discussions of Bebo's case.

Counsel for Bebo and the SEC said they had no objections to Judge Rovner hearing the appeal when the judge asked them. Judge Rover also reminded Mr. Cameli, who was at Bebo's counsel table, that he cannot talk to his sister about the case.

Also on the matter of the panel's familiarity with some of the lawyers on both sides of the *Bebo* case, one of the judges remarked when Stern rose to argue that Stern had been spending a lot of time in Chicago. Stern said "It's always a pleasure," to which the judge quipped that he had recently said during an oral argument in another case that it "is not always a pleasure." Stern replied that "hopefully today" it would be. The exchange was one of several moments of levity during the argument.

What's next for ALJ cases? Bebo's lawyers had asked the Seventh Circuit to hear her appeal on an expedited basis, which it did. Because Bebo's administrative proceeding has already consumed three weeks of testimony, and is set to resume by mid-June, Maternowski urged the appeals panel to likewise decide Bebo's federal case on an expedited basis.

Next up for the SEC is the oral argument before the Commission in *Timbervest* on Monday, June 8. That administrative proceeding also raises many of the same the constitutional issues asserted by Bebo, plus a new issue regarding the U.S. Constitution's appointments clause.

The *Timbervest* case also will consider a question raised by a *The Wall Street Journal* article about whether the SEC's Chief ALJ had pressured the agency's other ALJs to rule for the SEC's enforcement division. Specifically, the Commission invited ALJ Cameron Elliot, who is also hearing Bebo's administrative case, to submit an affidavit by July 1 stating his experience, if any, with pressure to rule for the SEC. Two footnotes in the Commission's order noted that ALJ Elliot's reply would be "voluntary," and that the affidavit, if he submits one, would be sealed to protect his confidentiality.

Several cases disputing the SEC's administrative regime in federal courts in Manhattan and in Georgia are still ongoing. Two of the earliest federal cases to challenge the SEC's ALJs have or will be voluntarily dismissed.

The case is No. 15-1511.

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Companies: Assisted Living Concepts, Inc.

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