

Another Loss for the CFPB: The DC Circuit Declares the CFPB's Structure Unconstitutional and Overturns Its Interpretation of RESPA

On October 11, 2016, the DC Circuit vacated a US\$109 million enforcement order by the Consumer Financial Protection Bureau (CFPB or Bureau) against mortgage lender PHH Corp., finding both the CFPB's structure unconstitutional and its interpretation of the Real Estate Settlement Procedures Act (RESPA) unreasonable.

The underlying dispute first arose in 2015, the result of which was a CFPB administrative law judge's recommendation of US\$6.5 million fine against PHH for allegedly requiring unlawful kickbacks from mortgage insurers in violation of Section 8 of RESPA. PHH appealed that decision to CFPB Director Richard Cordray, who rejected its arguments and then increased the fine to US\$109 million.

The Court Restructures the CFPB to Be an Executive Agency

Following PHH's petition for review of Director Cordray's order, the DC Circuit held that CFPB was too unaccountable to be constitutional. Created under the Dodd-Frank Act, the CFPB is an independent agency headed by a single director who is removable by the President only for cause. The CFPB Director enforces 19 federal consumer protection statutes that regulate everything from home finance to student loans to credit cards to banking practices. The court found that the concentration of enormous executive power in a single, unaccountable, unchecked CFPB Director not only "grossly" departs from settled historical practice, but also poses a far greater risk of arbitrary decision-making and abuse of power than would a multi-member independent agency or one with a Director who could be removed by the President at will.

To remedy this potential for abuse of power, the court ordered that the CFPB would no longer be an "independent" agency, but "now will operate as an executive agency" and that the President "now has the power to supervise and direct the Director of the CFPB, and may remove the Director at will at any time." The court also noted that Congress could return the CFPB to independence from the President by turning the directorship into a multi-member commission. As a practical matter, this means that the CFPB's Director has lost a significant amount of his insulation from the political process. For example, the newly elected President will be able to remove the CFPB Director even without reasonable cause.

The Court Rejects CFPB's Interpretation of RESPA

The DC Circuit's strong words about the potential for an abuse of power may have been prompted by the Bureau's many overly aggressive positions in the litigation, which the court uniformly rejected.

First, the court rejected the CFPB decision to discard HUD's longstanding interpretation of Section 8 of RESPA and interpreted the section to entirely bar so-called captive reinsurance arrangements, whereby the mortgage insurer pays no more than reasonable market value for the reinsurance. The court found that the CFPB could articulate no reasons to support this decision, that its interpretation was not entitled to *Chevron* deference because the statute was not ambiguous, and the CFPB's interpretation was unreasonable.

Second, even had the CFPB's interpretation of Section 8 been reasonable, the court concluded that the CFPB's decision to retroactively apply its new interpretation of RESPA to fine PHH US\$109 million "violated bedrock principles of due process." The court focused on the basic unfairness of issuing sanctions against a company for actions taken in reliance on HUD's prior interpretation, which had been outlined in both regulations and letters from senior HUD officials. Contrary to the CFPB's position, the court determined that the prior HUD interpretations need not be memorialized in formal rules and publications to provide third-party protection. While the CFPB was free to change the policy, consistent with the statutory underpinnings, it was not free to hold third parties accountable retroactively for not anticipating the CFPB's new interpretation.

Third, the court found that the CFPB's position that it "is free to pursue an administrative enforcement action for an indefinite period of time after the relevant conduct took place" to be "an absurdity." The CFPB had argued that because Dodd-Frank gave it power to enforce consumer protection laws, but did not explicitly mention the statutes of limitation in those laws, that the CFPB could pursue administrative enforcement actions without regard to when the conduct took place. The court rightly found that Dodd-Frank incorporates the statutes of limitation of the underlying statutes. In addition, the court found the conclusion of the CFPB that administrative proceedings should be distinguished from court cases on questions of statutes of limitation "flatly wrong."

The court vacated the CFPB's US\$109 million order against PHH, and, notably, the statutory rulings were unanimous. Only the constitutional finding regarding the CFPB's unitary executive was the subject of a sole dissent, which stated that the court did not need to reach the constitutional question.

Further Appellate Challenges to the DC Circuit's Decision

The CFPB is now left to seek a rehearing from the entire DC Circuit or to petition the US Supreme Court for review. While the DC Circuit takes exceedingly few cases *en banc*, and the odds against certiorari in the Supreme Court are always long, the case does feature a novel and important constitutional limitation on Congress' power to create agencies. At this point, it seems likely that the CFPB will pursue all paths to overturn the DC Circuit's decision. Agencies with a similar structure to the CFPB, such as the OCC and FHFA, and the enterprises they regulate, should be watching this case closely as well.

What Does This Decision Mean for Financial Services Providers?

- 1. More informal guidance.** The DC Circuit's decision should hamper the CFPB's longstanding policy of providing guidance to industry participants via enforcement actions, both administrative and in the federal courts. Financial services providers should expect more informal (and, perhaps, less hostile) guidance during audits, examinations and investigations. Do not be surprised if the CFPB moves to regulate more frequently through investigations rather than enforcement actions. While an investigation creates public records and can carry negative consequences, it may not trigger the due process concerns outlined by the DC Circuit. That said, it is not clear whether investigations, white papers or other forms of informal guidance will suffice to change the official interpretation under the DC Circuit's decision – but industry participants can feel more secure in relying on the kinds of non-precedential guidance at issue in *PHH Corp* given the court's rejection of the CFPB's argument that only guidance published in the Federal Register can serve as precedent.
- 2. Potentially less reliance on administrative enforcement actions.** Given the court's strong rejection of the distinction between administrative proceedings and court cases, at least on questions of statutes of limitation, the CFPB's use of administrative proceedings should diminish. While there is an argument that this will cause the Bureau to accelerate its cases to meet expiring statutes of limitation, there are some constraints on just how many it can prosecute at any one time. Whatever the case, the CFPB will not cease regulating by enforcement, but will only be more careful about doing so.
- 3. More challenges to the CFPB's pre-2016 regulations.** The decision potentially invalidates every CFPB regulation and interpretation created since July 2011. The CFPB had the power to make those regulations only because it had a Director properly vested with executive authority under Article II of the US Constitution – and the DC Circuit has now held that the directorship itself was structurally unconstitutional. This will likely lead to challenges to enforcement proceedings that are premised on a violation of those rules and regulations that are based on conduct occurring before October 2016.

Whether those challenges will be successful remains to be seen. In its 2014 decision in *Noel Canning v. NLRB*, the Supreme Court held that President Obama's recess appointments during pro-forma Senate sessions were unconstitutional. In the wake of that decision, CFPB Director Cordray had to be confirmed by the Senate. Afterwards, he ratified the actions he took while serving as an unconstitutional recess appointee. The Ninth Circuit accepted that ratification as valid to cure constitutional deficiencies in a then-pending enforcement action. Presumably, Director Cordray will issue yet another ratification after this latest setback. The retroactive effectiveness of that action will be a question for the courts.

- 4. Potentially less hostile interpretations by the CFPB.** This would represent a significant and welcome change to industry participants given the CFPB's aggressive actions on almost all fronts against providers of consumer financial services. A primary focus of the DC Circuit's opinion was that the CFPB was abusing its discretion in administering RESPA. It found the CFPB's interpretation of RESPA to be results-driven and the decision to ignore statutes of limitation to be wholly indefensible. With this pressure from the courts, and hopefully with guidance from the administration, it is possible the CFPB will be a little less unreasonably antagonistic to providers of financial services. However, this ruling is very unlikely to cause any immediate change to the day-to-day operations or the culture of the CFPB.

The Chances for Congressional Action on the CFPB

The DC Circuit's decision will place additional pressure on Congress to create a more balanced CFPB, perhaps with a change in leadership. The original legislation proposed by Senator Elizabeth Warren (D-MA) and others called for a five-member commission to head the Bureau. Yesterday's ruling will be perceived as a significant victory for those in Washington who have sought for years to curb the CFPB's power. Many people from both sides of the aisle, including House Financial Services Committee Chairman Jeb Hensarling (R-TX) and Senate Banking Committee Chairman Richard Shelby (R-AL), have long advocated to change the CFPB's sole directorship into a commission. The American Bar Association agrees, stating in response to the ruling that a "five-member, bipartisan commission, as originally proposed . . . would broaden the perspective on any rulemaking and promote fair enforcement activity at the Bureau, and it would provide necessary and appropriate checks and balances."

We expect lawmakers to use the court's decision to further two pieces of legislation that would: (1) replace the current single Director with a bipartisan, five-member commission; and (2) subject the CFPB to Congressional oversight and appropriations. Such legislation has already passed the House this year by a vote of 239-185, but has not made it to the Senate. However, it is unlikely that Congress will move on freestanding legislation reforming the CFPB this year. The best vehicle for immediate action would be the annual appropriations process, but that would face stiff opposition from President Obama and Senate Banking Committee Ranking Member Sherrod Brown (D-OH). The prospects of any significant changes, of course, will depend on which party controls the Senate after this November's election.

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