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October 13, 2016

## **D.C. Circuit Rules the Single-Director Structure of the CFPB Is Unconstitutional**

### **The Implications for the CFPB on the Eve of a Presidential Election**

On October 11, 2016, the D.C. Circuit Court of Appeals held in *PHH Corp. v. CFPB* that the structure of the Consumer Financial Protection Bureau (“CFPB”) as an independent agency headed by a single Director violated Article II of the Constitution.<sup>1</sup> As a remedy, the court struck the Director’s “for cause” removal protection, such that the CFPB would no longer be an “independent agency” but could continue to operate. We describe below the court’s ruling and explore the potential implications for the CFPB and regulated entities as we approach the presidential election.

#### **Background**

This case arises from an administrative enforcement proceeding that the CFPB brought against PHH Corporation, a mortgage lender, for alleged violations of section 8(a) of the Real Estate Settlement Procedures Act (“RESPA”). In short, the CFPB alleged that PHH, by referring homebuyers to mortgage insurers who in turn paid reinsurance fees to PHH’s captive reinsurer, was receiving kickbacks in violation of section 8(a) and not “bona fide” payments. An Administrative Law Judge (“ALJ”) entered a recommended decision finding liability, issued an injunction, and ordered disgorgement in the amount of \$6,442,399.

On an appeal to CFPB Director Richard Cordray, the Director upheld the ALJ’s recommended decision, but increased the disgorgement amount to \$109 million and ordered additional injunctive relief.

PHH petitioned the D.C. Circuit for review, challenging the CFPB’s constitutionality and various aspects of the CFBP’s enforcement order. Among other things, PHH argued that the CFPB erred in its interpretation of section 8 of RESPA, retroactively applied an interpretation of RESPA that differed from the longstanding interpretation of the Department of Housing and Urban Development (“HUD”) in violation of due process, and erred in finding that its administrative action under RESPA was not subject to any statute of limitations.

#### **D.C. Circuit’s Decision**

Vacating and remanding the CFPB’s decision, the D.C. Circuit held that the CFPB’s structure—“an independent agency headed by a single Director” rather than a multi-member commission—violated Article II of the Constitution. The court observed that independent agencies act as “a headless fourth

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branch of the U.S. Government,” and hence “pose a significant threat to individual liberty” and the established system of checks and balances. Emphasizing the importance of history and tradition, the court noted that independent agencies were generally led by “multiple commissioners, directors, or board members who act as checks on one another,” and remarked that the CFPB was originally conceived to be “a traditional, multi-member independent agency.” But Dodd-Frank ultimately established the CFPB as an agency headed by a single director.

The court found that the “CFPB is exceptional in our constitutional structure and unprecedented in our constitutional history.” The single-director structure, the court reasoned, created a “concentration of enormous executive power in a single, unaccountable, unchecked Director,” posing a “far greater risk of arbitrary decisionmaking and abuse of power, and a far greater threat to individual liberty” that made the CFPB structure unconstitutional.

With respect to the remedy for this constitutional violation, the court rejected PHH’s argument that the CFPB must be shut down pending a congressional fix. Rather, following the Supreme Court’s path in *Free Enterprise Fund v. Public Company Accountability Oversight Board*,<sup>2</sup> the court permitted the agency to continue to operate by severing the Director’s statutory “for cause” removal protection.<sup>3</sup> “As a result,” the court stated, “the CFPB now will operate as an executive agency. The President of the United States 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 stated in a footnote that it “need not here consider the legal ramifications of our decision for past CFPB rules or for past agency enforcement actions.”

The court next addressed the challenge to the CFPB’s disgorgement order, finding that the CFPB’s interpretation of section 8 of RESPA was incorrect. Reading sections 8(a) and 8(c) together, the court held that the statutory question was “not a close call” and that the “text of Section 8(c) permits captive reinsurance arrangements where mortgage insurers pay no more than reasonable market value for the reinsurance.” The court further held that, in any event, by retroactively applying a “newly minted interpretation” that “discarded HUD’s longstanding interpretation,” the CFPB violated PHH’s due process rights. In addition, the court rejected the CFPB’s argument that no statute of limitations applied because Dodd-Frank did not prescribe a statute of limitations for CFPB enforcement proceedings that it brings administratively, rather than in court. The court held that RESPA’s three-year limitations period applied.

The decision was issued by a divided panel. Judge Kavanaugh authored the majority opinion, joined by Judge Randolph (who also filed a concurrence); Judge Henderson concurred with the majority on the RESPA issues, but dissented from the court’s decision to reach the constitutional issues.

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### **Implications for the CFPB and Regulated Entities**

Having seemingly survived its first constitutional crisis—involving the legitimacy of Director Cordray's recess appointment—the CFPB has now entered its second, all in the course of its five years of existence. What happens next?

As an initial matter, PHH, the CFPB, or both may seek rehearing en banc and/or review before an (eight-member) Supreme Court.<sup>4</sup>

***How the next president may react to the ruling.*** Assuming there is no further review and the D.C. Circuit's decision stands, it is difficult to think about the implications for the CFPB without considering the upcoming election.

On the one hand, a new president could decide, as a matter of policy, to continue to treat the CFPB as an independent agency and not attempt to exert any increased supervision or direction over the CFPB's policies and actions. As the court's decision acknowledged, the Federal Communications Commission and the Securities Exchange Commission are treated as independent agencies, although they lack "for cause" removal protections. Such a president could even maintain a position of disagreement with the D.C. Circuit's decision, and there may be no obvious legal vehicle by which to challenge that stance. There could, however, be congressional hearings and investigations alleging that the president is abdicating his or her duty to supervise the CFPB Director.

On the other hand, a new president could decide to exert the power that the D.C. Circuit decision provides. The power to remove an appointee at will is the source of the president's practical ability to direct and supervise his or her subordinate's actions. Among other things, the president could amend Executive Order 12866, which currently excludes various independent agencies, to include the CFPB.<sup>5</sup> That Executive Order requires drafts of most significant proposed and final agency rulemakings to be distributed to executive branch agencies and various White House components for review prior to publication. It is the president's main source of control over agency rulemaking. If the CFPB resisted this action or the president's other attempts to exert control, the outcome could ultimately be a decision to remove the Director, with resulting litigation that may end up before the D.C. Circuit.

Of course, whether regulated entities would prefer a president to exert control over the CFPB likely depends on the identity of the president and his or her agenda. A president could push the CFPB to be even more aggressive than it is already perceived to be, or conversely could moderate its approach.

***Additional litigation to challenge past and future CFPB activity.*** It also seems likely that certain regulated entities will attempt to follow-up on the D.C. Circuit's footnote reserving the question of "the legal ramifications of our decision for past CFPB rules or for past agency enforcement actions." Plaintiffs may try to challenge existing CFPB rules and enforcement orders, claiming that the CFPB's

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unconstitutional structure made those rules and orders void upon issuance. In addition, regulated entities may try to challenge the CFPB's structure in other circuits, hoping to obtain the same ruling on the constitutional merits but a broader prospective remedy that prevents the CFPB from operating without a congressional fix. Challenges to CFPB actions are not funneled into the D.C. Circuit as they are in the case of some agencies; rather, they may be brought in any court where venue lies. There are plenty of existing and upcoming targets for such litigation, including the ambitious rulemakings that the CFPB is currently pursuing, such as involving arbitration clauses<sup>6</sup> and payday and other small-dollar lending.<sup>7</sup> Accordingly, this could be a time of increased regulatory uncertainty, as regulated entities and investors watch to see whether courts void past CFPB actions or adopt broader prospective remedies.

**Challenges to other agencies.** Finally, the D.C. Circuit's decision could be used to challenge the constitutionality of other independent agencies with a similar structure. As the decision acknowledges, the Federal Housing Finance Agency ("FHFA"), which is an independent agency created in 2008 that currently has Fannie Mae and Freddie Mac under conservatorship, is, like the CFPB, headed by a single director removable only for cause. The decision does not express any view about the constitutionality of the FHFA, noting only that it is "a contemporary of the CFPB" and thus "merely raises the same question we confront here."

In short, the likely near-term consequence of the D.C. Circuit decision is a period of uncertainty concerning the validity of the CFPB's past rulemaking and enforcement decisions, and a future regulatory agenda inextricably linked to the outcome of the presidential election.

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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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<sup>1</sup> See generally *PHH Corp. v. Cons. Fin. Protection Bureau*, No. 15-cv-01177 (D.C. Cir. Oct. 11, 2016).

<sup>2</sup> See generally *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010).

<sup>3</sup> “REMOVAL FOR CAUSE.—The President may remove the Director for inefficiency, neglect of duty, or malfeasance in office.” 12 U.S.C. § 5491 (c)(3) (2010).

<sup>4</sup> The CFPB’s ability to represent itself in the Supreme Court is subject to the procedures in 12 U.S.C. § 5564(e), which requires a request to the Attorney General.

<sup>5</sup> 58 Fed. Reg. 51735, Exec. Order No. 12866 3(b) (Sept. 30, 1993).

<sup>6</sup> For a discussion of CFPB’s arbitration rulemaking, see the Paul, Weiss Client Memorandum “[CFPB Proposes a Ban on Arbitration Clauses that Prevent Class Action Litigation.](#)”

<sup>7</sup> Roberto J. Gonzalez, [Taking Stock of CFPB’s Frenzied Agenda](#), Natl. L.J., June 3, 2016.