Financial Services & Products and Financial Services Litigation ADVISORY ■

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D.C. Circuit Issues Major Decision Addressing CFPB Structural and RESPA Section 8 Issues

On Tuesday, October 11, 2016, the U.S. Court of Appeals for the District of Columbia Circuit issued the court's highly anticipated decision addressing the Consumer Financial Protection Bureau's (CFPB)'s enforcement action against the mortgage lender PHH Corporation (PHH). The case before the court raised a number of novel questions regarding the single-director structure of the CFPB, the CFPB's authority with regard to prior agency interpretations, the status of informal interpretations issued by agencies, the CFPB's statute of limitations for bringing administrative and enforcement actions and longstanding questions involving the interpretation of "safe harbor" provisions within section 8 of the Real Estate Settlement Procedures Act (RESPA).

Overall, the tone of the court's opinion is generally critical of the CFPB's structure and arguments (especially on the CFPB's RESPA section 8(c) and statute of limitations interpretations) and could possibly undermine some of the other aggressive positions the CFPB has been taking. As discussed in more detail below, the CFPB's arguments failed on most points. The case was remanded to the CFPB for further proceedings consistent with the opinion including the court's restriction of the statute of limitations for RESPA enforcement actions by the CFPB to three years and whether the mortgage insurers paid more than reasonable market value for reinsurance. We expect the CFPB will appeal.

CFPB Enforcement Action and Administrative Appeal

In 2014, the CFPB brought an enforcement action against PPH generally alleging that PHH violated RESPA section 8(a) when PHH required private mortgage insurers – to whom PHH referred mortgage insurance business initially – to reciprocate by referring mortgage reinsurance business to PHH's affiliate, Atrium Insurance Corporation (Atrium), in a captive reinsurance arrangement, or otherwise not receive the initial mortgage insurance referrals. The Administrative Law Judge (ALJ) in the CFPB's Office of Administrative Adjudication found that PHH entered into agreements to refer borrowers to mortgage insurers in return for reinsurance premiums that the mortgage insurers paid to Atrium. The ALJ, however, relied on a 1997 letter from the U.S. Department of Housing and Urban Development (HUD) indicating that such a captive reinsurance arrangement could be permissible if the payments to the reinsurer were for the payment for goods or facilities actually furnished or for services actually performed as provided in the exemption of RESPA section 8(c)(2). The ALJ found that there was no effective risk transfer in certain cases and thus some payments were not for actual goods or services. The ALJ ordered injunctive relief and the disgorgement of $6.4 million for reinsurance premiums related to loans closed on or after July 21, 2008.

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PHH and the CFPB Office of Enforcement appealed the ALJ's decision to the director of the CFPB. The director departed from the 1997 HUD letter and interpreted RESPA section 8(c)(2) to not be a substantive exemption to liability. Instead, the director stated that section 8(c)(2) "only becomes relevant if there is a question as to whether the parties actually did enter into an agreement to refer settlement service business." The director also called for injunctive relief but ordered the disgorgement of approximately $109 million instead of $6.4 million. The director viewed every insurance premium that Atrium accepted on or after July 21, 2008, as a violation of RESPA section 8, including premiums paid for loans closed prior to that date. This differed from the ALJ's finding that amounts paid at closing for certain loans closed only on or after that date, which also did not meet the 8(c)(2) exemption, violated RESPA section 8.

CFPB Single-Director Structure & the Constitution

PHH argued that the CFPB's status as an independent agency headed by a single director violates Article II of the Constitution. The court recognized the extraordinary breadth of the CFPB's authority residing in a single director and found it to be unconstitutional unless the CFPB was structured as a commission or the director could be removed by the President "at will" instead of "for cause." The court stated that "[b]ecause the Director alone heads the agency without Presidential supervision, and in light of the CFPB's broad authority over the U.S. economy, the Director enjoys significantly more unilateral power than any single member of any other independent agency. By "unilateral power," we mean power that is not checked by the President or by other colleagues. Indeed, other than the President, the Director of the CFPB is the single most powerful official in the entire United States Government, at least when measured in terms of unilateral power."

The court also noted the scant Congressional Record materials on the structure of the CFPB with a single director and lack of any clear preference for that structure versus a commission structure. The court stated: "It bears mention that Congress's choice of a single-Director CFPB was not an especially considered legislative decision. There are no committee reports, nor substantial legislative history, delving into the benefits of single-Director independent agencies versus multi-member independent agencies. The CFPB has identified no congressional hearings studying the question. Congress apparently stumbled into this single-Director structure as a compromise or landing point between the original Warren multi-member independent agency proposal and a traditional executive agency headed by a single person."

Relying on established precedent, the court reached a narrower remedy by simply striking the "removal for cause" provision in Title X of the Dodd-Frank Act and left the single-director structure intact. Given this revision, the CFPB's single-director "at-will" structure matches that of other agencies, such as the U.S. Departments of Treasury and Justice.

The court, however, declined to address the effects of this change on the legality of prior CFPB rules and enforcement actions. Citing to prior decisions involving the National Labor Relations Board, the Court stated: "[W]ithout major tumult, the agencies and courts have subsequently worked through the resulting issues regarding the legality of past rules and of past or current enforcement actions."

Prior Agency Interpretations

The court determined that the CFPB's deviation from HUD's 1997 interpretation without prior notice is unconstitutional. On appeal from the ALJ, the CFPB director's opinion disregarded the section 8(c)(2) exemption noted in HUD's 1997 letter regarding permissible captive reinsurance arrangements relied upon by the ALJ (involving payment for goods or facilities actually furnished or for services actually performed). The court found this change of substantive direction via enforcement without prior notice to violate due process. The court stated "change becomes a problem – a fatal

one – when the Government decides to turn around and retroactively apply that new interpretation to proscribe conduct that occurred before the new interpretation was issued. Therefore, even if the CFPB's new interpretation were consistent with the statute (which it is not), the CFPB violated due process by *retroactively* applying that new interpretation to PHH's conduct that occurred *before* the date of the CFPB's new interpretation."

The court noted: "[A]t the time PHH engaged in its captive reinsurance arrangements, everyone knew the deal: Captive reinsurance arrangements were lawful under Section 8 so long as the mortgage insurer paid no more than reasonable market value to the reinsurer for reinsurance actually furnished." Referencing U.S. Supreme Court precedence, the court further stated: "The Due Process Clause limits the extent to which the Government may retroactively alter the legal consequences of an entity's or person's past conduct. That anti-retroactivity principle 'is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic' . . . . Retroactivity – in particular, a new agency interpretation that is retroactively applied to proscribe past conduct – contravenes the bedrock due process principle that the people should have fair notice of what conduct is prohibited. As the Supreme Court has emphasized, 'individuals should have an opportunity to know what the law is and to conform their conduct accordingly.'"

Reliance on Informal Interpretations

The court also found that the CFPB cannot disregard informal interpretations issued by agencies that industry reasonably relied upon to engage in private conduct. The court struck down the CFPB's argument that the CFPB could ignore HUD pronouncements that were not issued in a binding HUD rule.

The court stated: "The CFPB is confusing (i) the administrative law issue of whether an agency rule is sufficiently authoritative to obtain *Chevron* deference or to constitute a norm of proscribed conduct that the agency may enforce and (ii) the due process issue of whether an agency statement pronouncing the legality of certain conduct was sufficiently official for citizens to rely on it as the citizens arranged their conduct. To trigger the latter due process protection, an agency pronouncement about the legality of proposed private conduct need not have been set forth in a rule preceded by notice and comment rulemaking, or the like. Here, the agency guidance was provided by top HUD officials and was given repeatedly. Although we do not imply that those two conditions are necessary to justify citizens' reliance for purposes of the Due Process Clause, they are surely sufficient. Here, the regulated industry reasonably relied on those agency pronouncements. . . . The CFPB is arguing that it has the authority to order PHH to pay $109 million even though PHH acted in reliance upon numerous government pronouncements authorizing [under RESPA] precisely the conduct in which PHH engaged. The Due Process Clause does not countenance the CFPB's gamesmanship [attempting a retroactive legal interpretation]."

Statute of Limitations for CFPB Actions

The court concluded that the statute of limitations provisions in the substantive statutes administered by the CFPB controls and that the Dodd-Frank Act did not override them for CFPB actions. In this case, the three-year statute of limitations in RESPA for CFPB actions is controlling, whether brought as an administrative action or an enforcement action in court.

The CFPB argued that under the Dodd-Frank Act, there is no statute of limitations for administrative actions. According to the CFPB the statute of limitations provided for in the substantive rules administered by the CFPB, such as the three- year statute of limitations in RESPA, only applies to enforcement actions brought in court.

To be clear, the court further stated: "[T]he absurdity of the CFPB's position is illustrated by its response to a hypothetical question about the CFPB's bringing an administrative enforcement action 100 years after the allegedly unlawful conduct. Presented with that question, the CFPB referenced its prosecutorial discretion. But 'trust us' is ordinarily not good enough. . . . This Court looks askance now at the idea that the CFPB is free to pursue an administrative enforcement action for an indefinite period of time after the relevant conduct took place. A much more logical, predictable interpretation of the agency's authority is that the three-year limitations period in Section 2614 applies equally to CFPB court actions and CFPB administrative actions. And most importantly for our purposes, that is what the relevant statutes actually say."

The court declined to address whether each alleged above reasonable market value insurance premium would trigger a new three- year statute of limitations. The court expressly left "that question to the CFPB on remand and any future court proceedings."

RESPA Section 8 "Safe Harbors"

Section 8 Overview

RESPA, 12 U.S.C. §§ 2601 et seq., as implemented by Regulation X, 24 C.F.R. Part 3500, establishes civil and criminal penalties for improper referrals and fee splitting arrangements involving settlement service businesses. Toward that end:

Section 8(a) of RESPA prohibits the payment or acceptance of any "fee, kickback or thing of value" as part of an agreement for a referral of business incident to or part of a "real estate settlement service" involving a federally related mortgage loan secured by a first or subordinate lien on real property. 12 U.S.C. § 2607(a).

Section 8(b) of RESPA prohibits any fee-splitting in connection with a "real estate settlement service" not related to any services actually performed. 12 U.S.C. 2607(b).

Section 8(c) sets out a list of payments that are not prohibited by section 8. Among these exempted payments are payments of a fee by a lender to its duly appointed agent for services actually performed in the making of a loan. 12 U.S.C. § 2607(c)(1)(c). Also exempted are payments to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed. 12 U.S.C. § 2607(c)(2). Section 8(c)(4) additionally contains a specific exemption for affiliated business arrangements (AfBA), which include referrals among affiliated entities, and spells out the conditions under which such arrangements are permitted. 12 U.S.C. § 2607(c)(4). Under Regulation X, an AfBA is an arrangement in which:

a) a person who is in a position to refer settlement business, or an associate[1] of such person either is affiliated with, or owns more than 1 percent in a settlement service provider, and
b) such person directly or indirectly refers business to that provider.

24 C.F.R. § 3500.14(d).

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[1] Under Regulation X, an "associate" of a particular person is:

(i) a spouse, parent or child of such person;
(ii) a corporation or other business entity that controls, is controlled by, or is under common control with such person;
(iii) an employer, officer, director, partner, franchiser or franchisee of such person; or
(iv) anyone who has an agreement or understanding with such person, the purpose or substantial effect of which is to enable such person to benefit financially from the referral of business incident to or part of a settlement service."

Section 8(d)(1) of RESPA specifies criminal penalties of up to a $10,000 fine or one (1) year in prison or both for violations of Section 8. 12 U.S.C. § 2607(d)(1). Section 8(d)(2) authorizes a private right of action for RESPA violations in which a person violating section 8 shall be liable for three (3) times the amount of the settlement service charge. 12 U.S.C. § 2607(d)(2).

CFPB Director's Opinion

The CFPB director contended on appeal that "i*t is a violation of Section 8(a) when a lender makes referrals to a real estate service provider in exchange for the purchase of goods or services at any price – as consideration for making referrals, and that such a violation cannot be saved by Section 8 (c)(2)*." (Emphasis added.) The director noted, however, that RESPA would not be violated if PHH referred customers to mortgage insurers, and separately, Atrium could perform reinsurance services for mortgage insurers. The director asserted that "PHH's violation of Section 8(a) occurred because the mortgage insurers' payments were linked to (and therefore served as compensation for) PHH's referrals."

The nature of the PHH arrangement and its *quid pro quo* nature may have raised the director's ire, but in a stark divergence from previous HUD interpretations of RESPA, the director declared that in effect, *any* arrangement involving the referral of settlement service business between settlement service providers violates RESPA, regardless of the underlying actual services being performed by the parties to the arrangement and the reasonableness of the compensation charged to consumers.

The Court's View of Section 8(c)(2)

The court began its analysis by stating that "the basic statutory question in this case is not a close call. 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 specifically deemed RESPA section 8(c)(2) to be a "safe harbor" and not interpretive provisions of RESPA section 8. The court stated: "[S]ection 8(c), carved out a series of *expansive exceptions, qualifications, and safe harbors* related to Section 8(a). Of relevance here, Section 8(c) provides: 'Nothing in this section shall be construed as prohibiting . . . (2) the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed . . . .'" (Emphasis added.)

The court also addressed the CFPB's view that referral arrangements themselves violate RESPA section 8 regardless of the amount paid for goods or services. The court stated: "[T]o be sure, one might say that the mortgage insurer – although paying reasonable market value for the reinsurance – would have preferred not to purchase reinsurance at all or to purchase it from a different reinsurer. In that sense, the lender's actions create a kind of tying arrangement in which the lender says to the mortgage insurer: We will refer customers to you, but only if you purchase another service from our affiliated reinsurer, albeit at reasonable market value. But the statute does not proscribe that kind of arrangement. As relevant here, Section 8(a) proscribes payments for referrals. Period. It does not proscribe other transactions between the lender and mortgage insurer. Nor does it proscribe a tying arrangement, so long as the only payments exchanged are bona fide payments for services and not payments for referrals."

The court went on to state that tying in the U.S. is rarely prohibited. The court noted: "The CFPB says, however, that the mortgage insurer's payment for the reinsurance is not 'bona fide' if it was part of a tying arrangement. That makes little sense. Tying arrangements are ubiquitous in the U.S. economy. To be sure, tying arrangements are outlawed in certain circumstances, but they were not outlawed by Section 8 in the circumstances at issue here. A payment for a service pursuant to a tying arrangement does not make the payment any less bona fide, so long as the payment for the service reflects reasonable market value. A bona fide payment means a payment of reasonable market value."

In addressing the CFPB's argument that it should be entitled to *Chevron* deference, the court highlighted that deference to the CFPB is not required where no ambiguity in the statutory interpretation currently exists. The court succinctly stated that "Section 8(c) eliminates any potential ambiguity that might have existed if all we had were Section 8(a) alone. Section 8(c) clearly permits captive reinsurance arrangements so long as the mortgage insurer pays reasonable market value for reinsurance actually provided. So the CFPB's interpretation fails at *Chevron* step one."

What Does the Decision Mean?

CFPB Authorities

- The CFPB generally must rely on prior opinions and interpretations issued by the transferor agencies unless the CFPB gives appropriate notice that they no longer have effect. Widely circulated guidance issued by higher-level staff likely cannot be ignored.

- The CFPB's informal written interpretations for RESPA and other statutes such as the Truth in Lending Act and Home Mortgage Disclosure Act, including the small entity compliance guides, may be relied upon by industry participants without them being subject to enforcement liability, regardless of whether the CFPB states they are not official interpretations and cannot be relied upon for any purpose. There is still a question of whether they provide sufficient protection in private litigation.

- The court referenced the notable light Congressional Record on the structure of the CFPB with a single director and the lack of Congress's clear preference for that structure versus a commission structure. We note that the Congressional Record for many provisions of the Dodd-Frank Act is similarly light or non-existent. This may come into play in later court decisions on the substantive Dodd-Frank Act laws and related CFPB Title XIV rules, such as the ability to repay, loan originator compensation, appraisal and servicing rules.

- The statute of limitations in the substantive rules (the Enumerated Consumer Laws) likely controls the CFPB's ability to bring actions and not Title X theories unless the substantive rules are silent in this regard. Each substantive rule other than RESPA would need to be reviewed in light of the court's analysis. It is unclear whether these limitations will require the CFPB in future investigations and civil investigative demand (CID) negotiations to back down from the position that the CFPB can insist on CID data production clearly outside of the statute of limitations period. Moreover, the effect of this decision on equitable tolling doctrine arguments regarding the CFPB's statute of limitations in other cases involving laws administered by the CFPB is also an uncertain issue.

- Even though the CFPB single-director structure remains in place, the legality of prior CFPB rules and enforcement actions remains unclear. We presume they have effect unless or until a new director is installed who overturns them. If, however, the current director were removed by President Obama, that would likely cloud everything the CFPB has done to this point.

- All in all, it will likely be business as usual for the CFPB until these constitutional issues are resolved.

RESPA Section 8 and the Return of MSAs?

It remains to be seen what determinations the CFPB will make on remand if the CFPB reconsiders the RESPA section 8 issues in light of the decision. The CFPB will likely appeal the decision first. If the full panel of the D.C. Circuit (*en banc review*) and the U.S. Supreme Court ultimately deny the appeal, industry may reconsider current approaches to the marketing services agreements (MSAs). Most in industry either terminated existing MSAs or reworked them

to steer clear of activities with less grounding in other industries or with less potential for objective valuations. If the D.C. Circuit agrees to review the decision *en banc* first, it may be wise to wait until the Supreme Court acts before revising agreements. If the High Court hears the case, its current eight-member panel and the impending presidential election may complicate the Court's decision whether to take the case and the outcome. A 4-to-4 tie would leave the lower court's decision in effect.

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