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October 14, 2016

Financial Institutions Alert

D.C. Circuit Delivers a Major Setback to the CFPB

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On October 11, the D.C. Circuit issued a major decision holding the structure of the Consumer Financial Protection Bureau (CFPB) unconstitutional and sharply limiting the CFPB's enforcement powers. The decision granted a sweeping victory to PHH Corporation and its affiliates (PHH) in their appeal of an administrative decision by CFPB Director Richard Cordray, which found that PHH's captive reinsurance arrangements violated the Real Estate Settlement Procedures Act (RESPA) and imposed disgorgement of over $109 million. The D.C. Circuit vacated Director Cordray's decision and remanded the matter to the CFPB for additional proceedings. Judge Kavanaugh authored the opinion, and was joined by Senior Judge Randolph. Judge Henderson dissented from the majority's decision on the constitutional issue, but joined the majority's resolution of the RESPA issues.

Key takeaways:

- The decision is a significant constitutional ruling, but the court's limited remedy means that the CFPB will likely continue functioning as before.
- The decision is a major setback for the CFPB's aggressive RESPA enforcement program, in which it has sought enormous disgorgement amounts from companies engaged in captive reinsurance arrangements.
- The decision also roundly rejects the CFPB's claim that its administrative actions are not subject to any statute of limitations, undercutting the Bureau's aggressive approach to statute of limitations issues.

Background

The case involved captive reinsurance arrangements, in which a mortgage lender refers borrowers to a mortgage insurer, and in return, the mortgage insurer buys reinsurance from a mortgage reinsurer affiliated with the lender. Such arrangements were common in the mortgage insurance industry as far back as 1997, when the Department of Housing and Urban Development (HUD) recognized that they were permissible under RESPA as long as the amount paid by the mortgage insurer for the reinsurance did not exceed the reasonable market value of the reinsurance. In 2011, enforcement authority under RESPA was transferred to the CFPB, which did not issue any contrary regulations or guidance.

Nevertheless, in 2014, the CFPB brought an administrative enforcement action against PHH, a mortgage lender, relating to PHH's use of captive mortgage reinsurance arrangements. The CFPB alleged that the arrangements amounted to an illegal kickback scheme in violation of

RESPA. An Administrative Law Judge (ALJ) ruled in favor of the CFPB and ordered PHH to pay $6.5 million as disgorgement. The ALJ's ruling was appealed to Director Cordray, who issued a much broader ruling against PHH, imposing additional injunctive relief and dramatically increasing the disgorgement amount to $109 million.

PHH filed a petition for review of the director's decision in the D.C. Circuit. PHH made a number of arguments on appeal. First, and most significantly, PHH argued that the CFPB's structure—featuring a single director who is not removable at will by the President—was unconstitutional. Second, PHH argued that the CFPB incorrectly interpreted RESPA to effectively prohibit captive reinsurance arrangements, and that the CFPB violated its due process rights by applying this novel interpretation retroactively. Third, the court was presented with the issue of whether the CFPB's administrative action was subject to the statute of limitations in RESPA.

CFPB Held Unconstitutional

The court's holding that the CFPB's structure is unconstitutional has rightly attracted significant media attention.[1] It represents a major ruling not only for the CFPB, but also for the development of broader separation-of-powers principles. Judge Kavanaugh's opinion engages in an extensive analysis of those principles in concluding that the Constitution prohibits vesting the authority of an executive agency in a single person who is not removable at-will by the President.

The opinion carefully reviews the history of independent agencies—reaching back to the 1887 Interstate Commerce Commission—and concludes that the "CFPB is the first of its kind and a historical anomaly."[2] Unlike the CFPB, which is run by a single director, other independent agencies exercising substantial authority have all been multi-member commissions or boards. The court cited only a single agency that is structured in a manner similar to the CFPB: the 2008 Federal Housing Finance Agency (FHFA) (on which the court also cast doubt).[3] The court also distinguished the Social Security Administration and the Office of Special Counsel—also independent agencies headed by a single director— from the CFPB because neither agency has the "authority to enforce laws against private citizens, and does not have power to impose fines and penalties on private citizens."[4]

In describing the historical practice of structuring independent agencies as multi-member commissions or boards, the court's opinion explains that multi-member agencies typically pass constitutional muster because a multi-member structure helps to prevent arbitrary decision making, is less likely to be captured or unduly influenced by interest groups, and tends to be more deliberative.[5] By contrast, the concentration of power in the hands of one individual is more prone to abuse of power and arbitrary decisions. The court stated that "the Director of the CFPB is the single most powerful official in the entire U.S. Government, other than the President," and concluded that this concentration of power without sufficient control by the President is not constitutionally permissible.[6]

The court's analysis can be seen, in part, as an extension of the Supreme Court's recent skepticism regarding congressional constraints on Presidential control of Executive officers.

[1] Arguments related to the constitutionality of the CFPB have been raised and rejected in several district court cases prior to this decision. *See, e.g.*, *CFPB v. Morgan Drexen, Inc.*, 60 F. Supp. 3d 1082 (C.D. Cal. 2014); *CFPB v. ITT Educ. Servs., Inc.*, --- F.Supp.3d ---, 2015 WL 1013508 (S.D. Ind. Mar. 6, 2015).
[2] Op. at 27.
[3] Op. at 33-34.
[4] Op. at 32.
[5] Op. at 43-53.
[6] Op. at 6, 23. The court notes that the original proposal for the CFPB from then-Professor Elizabeth Warren was for the CFPB to operate as a multi-member independent agency. Op. at 23.

That skepticism found perhaps its greatest expression in the late Justice Scalia's dissent in *Morrison v. Olsen*,[7] which in time came to be widely praised and which the *PHH* opinion cites extensively. A similar wariness of limits on Presidential control of Executive officers informed the Supreme Court's 2010 decision in *Free Enterprise Fund v. Public Company Accounting Oversight Board,*[8] which held unconstitutional a structure that insulated agency heads from Presidential control with two levels of for-cause removal protection. Judge Kavanaugh wrote a stinging dissent in the *Free Enterprise Fund* case in the D.C. Circuit, and was vindicated when the Supreme Court ultimately adopted his position in part.[9] The opinion in *PHH* reflects the further advance of Judge Kavanaugh's views on the importance of Presidential control over officials who exercise Executive power.

Despite the sweep of the court's constitutional holding, the court applied a limited constitutional remedy: Rather than invalidate the CFPB altogether, as argued by PHH, the court held that the proper remedy was to sever the for-cause removal provision from the Dodd-Frank Act. As a practical matter, this means that the "CFPB . . . will continue to operate and to perform its many duties, but will do so as an executive agency akin to other executive agencies headed by a single person, such as the Department of Justice and the Department of the Treasury."[10] This is the same limited remedy that was applied by the Supreme Court in *Free Enterprise Fund*. As in that case, the court's remedy vindicates Presidential control over the agency while allowing the agency to continue to function.

The court declined to resolve an important final issue: "the legal ramifications" of its constitutional holding "for past CFPB rules or for past agency enforcement actions."[11] Although the court's holding would seem to cast doubt on every action undertaken by the CFPB to date, as a practical matter, there are indications that the CFPB's prior actions will be treated as valid. For one, the court stated that "this is not an uncommon situation" and that, "[w]ithout major tumult," other agencies found to have constitutional defects have "subsequently worked through the resulting issues regarding the legality of past rules and of past or current enforcement actions."[12] The court cited two recent cases in which challenges to the past decisions of unconstitutionally constituted multi-member boards were denied on the basis that reconstituted boards had ratified the challenged decisions.[13] Moreover, in similar circumstances, courts have been wary of inviting "the chaos that would result from multiple and repetitious suits challenging every action taken by every official whose claim to office could be open to question[.]"[14] Although the issue is not straightforward, it would not be surprising if courts were to adopt a similar approach here.

RESPA Liability Issues

Beyond the constitutional issue, and perhaps of greater practical import, the *PHH* decision imposes significant limits on the CFPB's aggressive RESPA enforcement program. The CFPB's action against PHH had sought to impose a new interpretation of RESPA that would essentially prohibit captive reinsurance arrangements and to require massive disgorgement of reinsurance premiums. The court threw all of this out.

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[7] 487 U.S. 654, 706 (1988) (Scalia, J., dissenting).
[8] 561 U.S. 477 (2010).
[9] 537 F.3d 667 (D.C. Cir. 2008) (Kavanaugh, J., dissenting).
[10] Op. at 10.
[11] Op. at 69-70 n.19.
[12] *Id.*
[13] *Noel Canning v. NLRB*, 823 F.3d 76, 78-80 (D.C. Cir. 2016); *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, 796 F.3d 111, 118-19 (D.C. Cir. 2015).
[14] *Ryder v. United States*, 515 U.S. 177, 180-81 (1995) (internal quotation marks and citation omitted); *see also id.* at 180 (recognizing the "de facto officer doctrine," which "confers validity upon acts performed by a person acting under the color of official title even though it is later discovered that the legality of that person's appointment or election to office is deficient.").

Section 8(a) of RESPA prohibits the payment or receipt of "any fee, kickback, or thing of value pursuant to any agreement or understanding . . . that business incident to or a part of a real estate settlement service . . . shall be referred to any person."[15] This broad restriction is qualified by Section 8(c), which includes a number of safe harbors and exceptions. Among them is an exception stating that "[n]othing in this section shall be construed as prohibiting . . . 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."[16] This provision had been consistently interpreted to allow for captive reinsurance arrangements as long as the mortgage insurer paid no more than reasonable market value for the reinsurance. In 1997, for example, HUD—previously responsible for enforcing RESPA—issued an interpretive letter stating that these arrangements are permissible as long as the reinsurance services were actually furnished or performed and the bona fide compensation does not exceed the value of such services.[17] This interpretation is reflected in regulations originally promulgated by HUD and subsequently adopted by CFPB regulation.[18]

Despite this longstanding interpretation of RESPA, Director Cordray interpreted the term "bona fide" to require that the payment not be "tied in any way to a referral of business."[19] Director Cordray flatly rejected the 1997 HUD Letter as valid guidance and concluded that it was not binding.[20] His decision relied on this novel interpretation to find that PHH violated RESPA each time it received a reinsurance payment from a captive insurer.[21]

The D.C. Circuit rejected the Bureau's new interpretation of RESPA on two grounds. First, it rejected the Bureau's view that a mortgage insurer's payment for reinsurance is not "bona fide" if it is part of a tying arrangement. The opinion does not regard this issue as "a close call," explaining that "[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[,]" and that "[a] bona fide payment means a payment of reasonable market value."[22] The CFPB's interpretation, the court wrote, "flouts not only the text of the statute but also decades of carefully and repeatedly considered official government interpretations."[23] HUD's "longstanding interpretation" of RESPA is therefore the correct one: Section 8 allows captive reinsurance arrangements as long as the amount paid by the mortgage insurer for the reinsurance does not exceed the reasonable market value of the reinsurance.

Second, the court ruled that the Bureau's reversal of prior HUD guidance and retroactive application of its new interpretation violates due process. Agencies are permitted to change their interpretive position, the court explained, but they may not retroactively apply a new interpretation to past conduct without providing fair notice. Here, the Bureau's interpretation represented a "complete about-face from the Federal Government's longstanding prior interpretation" and violated due process to the extent that it was applied retroactively. Op. at 79.

The opinion reviewed Regulation X, the 1997 HUD Letter, and a similar 2004 letter from HUD, and it concluded that the prevailing interpretation of RESPA prior to the CFPB was that

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[15] 12 U.S.C. § 2607(a).
[16] 12 U.S.C. § 2607(c)(2).
[17] Letter from Nicolas P. Retsinas, Assistant Secretary for Housing, Department of Housing and Urban Development, to Countrywide Funding Corporation (Aug. 6, 1997) (1997 HUD Letter).
[18] *See* 12 C.F.R. § 1024.14(g)(1)(iv).
[19] Decision of the Director, *In the Matter of PHH Corp., et al.*, 2014-CFPB-0002 (June 4, 2015), at 17 ("Cordray Decision").
[20] *Id.* at 17-18.
[21] *Id.* at 15-26.
[22] Op. at 73-75.
[23] Op. at 76. The court also rejected the CFPB's argument that its novel interpretation of RESPA is entitled to *Chevron* deference, concluding that Sections 8(a) and 8(c) are unambiguous. Op. at 77-78.

"[c]aptive 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."[24] The CFPB argued that regulated entities had no reason to rely on this guidance—a claim the Court found "deeply unsettling in a Nation built on the Rule of Law."[25] The court rejected the CFPB's position, likening it to that of a police officer ticketing an individual for jaywalking after the officer just told the person it was permissible to cross the street, and concluding that the "Due Process Clause does not countenance the CFPB's gamesmanship."[26]

The court's due process ruling has the potential to have a broader effect on the CFPB's enforcement program beyond RESPA. The CFPB has at times taken aggressive or novel legal positions in enforcement actions that are not always consistent with prevailing industry understandings or regulatory interpretations. This approach has sometimes been criticized by industry groups as "regulation through enforcement," a charge that Director Cordray has rejected.[27] The *PHH* decision suggests that the CFPB's approach faces limits: Where a party can point to inconsistent prior regulatory guidance or interpretations, due process considerations may prevent the Bureau from applying its interpretation retroactively.[28]

Statute of Limitations

The decision is also significant in its rejection of the CFPB's claim that it is not bound by any statute of limitations period in administrative proceedings. The court ultimately held that a three-year statute of limitations applies to all Bureau RESPA actions, whether pursued in court or in an administrative forum.

In his decision, Director Cordray ruled that the CFPB's authority is not constrained by any limitations period when bringing an administrative enforcement proceeding because the provision of Dodd-Frank authorizing the CFPB to pursue administrative enforcement does not contain an express limitations period.[29] This is in contrast, the CFPB argued, to the provision of Dodd-Frank authorizing the CFPB to file suit in court, which contains an express three-year limitations period from the discovery date.[30]

The D.C. Circuit rejected this argument as "absurd." Op. at 99. The court first pointed out that the CFPB's authority to enforce the enumerated consumer protection laws is limited where "such Federal law specifically limits the Bureau from conducting a hearing or adjudication proceeding." Op. at 93 (citing 12 U.S.C. § 5563(a)(2)). Thus, under the plain language of Dodd-Frank, to the extent that one of the enumerated consumer protection laws contains an applicable limitations period, this period would apply to the Bureau's administrative forum. As for the RESPA statute of limitations, the court rejected the argument that the term "actions" in RESPA does not apply to administrative proceedings. The court pointed to various provisions in Dodd-Frank where the term "action" encompasses both administrative and court actions.

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[24] Op. at 82.
[25] Op. at 87.
[26] Op. at 88.
[27] Richard Cordray, Director, CFPB, Prepared Remarks at the Consumer Bankers Association (March 9, 2016), *available at* http://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-consumer-bankers-association/.
[28] The court did not address Director Cordray's ruling that the amount of disgorgement is the entire amount of premiums paid, with no offset for claims paid. Cordray Decision, at 33-35. The court states that the "disgorgement remedy is the amount that was paid above reasonable market value," but it does not address the issue of offsets. Op. at 79 n. 24. In her concurrence, Judge Henderson concludes that the disgorgement sanction must be reduced "by the amount the captive reinsurer paid the insurers for their reinsurance claims." Henderson Op. at 1.
[29] Cordray Decision, at 10; 12 U.S.C. § 5563 (authorizing administrative enforcement).
[30] 12 U.S.C. § 5564(g).

The *PHH* case is not the only time the CFPB has pushed the envelope with regard to limitations periods. The Bureau has sometimes taken aggressive positions on statute of limitations issues during negotiations, which may increase its leverage in a settlement.[31] In its administrative enforcement proceeding against Integrity Advance, the Bureau argued successfully to the ALJ that it is not bound by the limitations periods in the Truth in Lending Act and the Electronic Funds Transfer Act.[32] The CFPB has made other aggressive limitations arguments—in several cases, for example, the Bureau has argued that limitations periods only apply to private suits, and not to government enforcement actions.[33]

Courts that have considered these arguments have generally expressed skepticism at the idea that the CFPB is not bound by a limitations period. In *Hanna* and *ITT*, for example, courts rejected arguments that no limitations period applied to Bureau enforcement actions.[34] In this case, the opinion notes the presumption that federal causes of action have a limitations period, and expressed doubt that Congress sought to allow the CFPB to circumvent statutory limitations periods in all of the enumerated consumer protection laws simply by bringing an administrative action.[35] Indeed, the court described the Bureau's argument on this point as "absurd" and "alarming," particularly because the Bureau can impose penalties and monetary relief in administrative proceedings.[36] The court's opinion questions whether the Bureau could bring an administrative proceeding "100 years after the allegedly unlawful conduct," and roundly rejects the CFPB's argument that the public simply needs to "trust us" to exercise prosecutorial discretion. Op. at 100. Although we expect that the Bureau will continue to test the scope of the limitations periods that apply to its actions, the *PHH* decision will provide a strong precedent for defendants to argue in favor of reasonable limits.

Next Steps in PHH

The PHH dispute is not over. The CFPB has 45 days from the date of the judgment to seek rehearing by the *en banc* D.C. Circuit. And given the significance of the decision, the CFPB is likely to take that step. Even if the decision is not reheard *en banc*, the CFPB could seek review by the Supreme Court, where the panel's constitutional ruling could attract significant interest. If Justice Scalia were still on the Court, PHH could have reasonable confidence that the panel's decision would survive Supreme Court review, but the decision's prospects with the Court's current composition are less clear.

[31] For example, the application of the three-year discovery rule in 12 U.S.C. § 5564(g)(1) is an issue in the Bureau's enforcement action against Intercept Corporation. In its motion to dismiss, Intercept stated that the Bureau "in discussions" has "contended that a violation . . . is 'discovered' when Bureau Director Richard Cordray personally concludes as much, apparently only after Bureau enforcement staff has formally closed its inquiry and submitted a recommendation to the Director." *See* Memorandum of Law in Support of Defendants' Motion to Dismiss the Complaint at 11, *CFPB v. Intercept Corp.*, No. 3:16-cv-00144 (D. N.D. Aug. 8, 2016), Doc. No. 19.
[32] *See* Bureau's Opposition to Respondents' Motion to Dismiss at 10–14, In the Matter of Integrity Advance, LLC, 2015-CFPB-0029 (Jan. 15, 2016), Doc. No. 33.
[33] CFPB's Opposition to ITT's Motion to Dismiss the Complaint at 32, *CFPB v. ITT Educ. Servs, Inc.*, No. 1:14-cv-00292 (S.D. Ind. June 12, 2014), Doc. No. 25; Plaintiff's Response to Defendants' Motion to Dismiss at 34-38, *CFPB v. Frederick J. Hanna & Assocs., P.C.*, No. 1:14-cv-02211 (N.D. Ga. Oct. 3, 2014), Doc. No. 26.
[34] *CFPB v. Frederick J. Hanna & Assocs., P.C.*, 114 F. Supp.3d 1342, 1375–78 (N.D. Ga. 2015); *ITT Educ. Servs.*, 2015 WL 1013508, at *32-33.
[35] Op. at 98-99 ("Congress does not, one might say, hide elephants in mouseholes." (citing *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S.Ct. 1938, 1947 (2016))).
[36] Op. at 99. For purposes of RESPA claims, one significant issue left open by the court is whether the limitations period is triggered by the origination of the loan or the receipt of above-market premiums. Op. at 100.

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