HUNTON& WILLIAMS

# Client Alert

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## Is The Current Structure of the CFPB Unconstitutional?

In response to the financial crisis and the "Great Recession," in 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Recently, the Treasury Department described Dodd-Frank as "a dense 2,319 page piece of legislation that is sweeping in its scope and mandates."[1] As a result of the enactment of Dodd-Frank, Congress "delegated unprecedented authority to financial regulators and mandated hundreds of new regulations."[2] The number of regulations that have been implemented as a result of Dodd-Frank is unknown—according to the Treasury Report, "implementing Dodd-Frank required approximately 390 regulations, implemented by more than a dozen different regulatory agencies."[3] Among the regulatory agencies prolifically issuing regulations is the Consumer Fraud Protection Bureau ("CFPB"), which was created as a brand-new, start-up independent agency under Dodd-Frank.

Since its enactment, a number of pieces of Dodd-Frank have been the subject of extensive criticism from certain industry participants and certain political quarters. With the election of President Trump and the Republicans maintaining control of both houses of Congress, the efforts to reform the provisions of Dodd-Frank have increased. As the efforts to reform Dodd-Frank progress, Hunton & Williams LLP will issue a series of client alerts relating to the efforts.

From a political standpoint, one of the highest-profile reforms proposed by in Congress is a reform of the CFPB. Each branch of the federal government has recently raised questions about the structural constitutionality of the CFPB and proposed reform. For example, this year the House of Representatives passed the Financial Choice Act, which includes sweeping reforms to the CFPB, and the Treasury Report included numerous recommendations to reform the CFPB. Further a panel decision from the Court of Appeals for the District of Columbia Circuit ruled in October, 2016 that the structure of the CFPB is unconstitutional. Consequently, the first series of client alerts will address reform of the CFPB. In this client alert, we will examine the structure of the CFPB to highlight the concerns that have been raised about the constitutionality of its structure, including the arguments and concerns that are pending before the United States Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") in *PHH Corporation v. CFPB.*[4]

**Structural Problems with CFPB**

Explaining the controversy surrounding the CFPB requires a quick reminder about the basic structure of the United States government. Under the Constitution of the United States, the federal government was established with three separate and equal branches:

- Article I of the Constitution established the two chambers of Congress which were vested with legislative powers;

[1] See, "A Financial System That Creates Economic Opportunities," Report to President Donald J. Trump, June 2017 (the "Treasury Report").
[2] Id
[3] Id
[4] *PHH Corporation, et. al. v. Consumer Financial Protection Bureau*, No. 15-1177 pending in the United States Court of Appeals for the District of Columbia Circuit.

 

- Article II of the Constitution established the office of the president and vested in the president (and through the president to the inferior officers) all executive powers; and

- Article III of the Constitution established the Supreme Court and vested in it (and such inferior courts created by Congress), the judicial powers.

When establishing the government, the framers of the Constitution understood the threat  to individual liberty that resulted from consolidated power in the hands of a single person. Indeed, the "declared purpose of separating and dividing the powers of government, of course, was to difus[e] power, the better to serve liberty."[5]

Almost since the creation of the CFPB, many commentators have argued that the structure of the independent CFPB is unconstitutional as a result of consolidating in it all governmental power relating to a significant portion of the United States economy.[6]  For example, Dodd-Frank created the CFPB and vested it with:

- The legislative power through the CFPB's rule making power[7] and ability to designate the industries subject to its oversight;[8]

- The executive power through the CFPB's investigative and enforcement authority;[9] and

- The judicial power through the CFPB's authority to rule on enforcement actions with any appeals on such actions being taken to the director of the CFPB.[10]

To add further risk, the CFPB is not subject to any effective oversight by the constitutionally created branches of the government. Indeed:

- Unlike most executive branch officers who serve at the pleasure of the president, the CFPB director cannot be terminated by the president except "for cause" and the president therefore does not have effective oversight of the CFPB;[11] and

- Congress does not have effective oversight because the CFPB is not funded by Congress through the general appropriation process, but rather it is partially funded by the Federal Reserve and is partially self-funded from fines it imposes on those entities it regulates.

As a result of this concentration of power, a panel of the D.C. Circuit stated that the "Director of the CFPB is the single most powerful official in the entire U.S. Government, other than the President. Indeed, within his jurisdiction, the Director of the CFPB can be considered even more powerful than the President. It is the Director's view of consumer protection law that prevails over all others."[12]

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[5] *Bowsher v Syner*, 478 U.S. 714, 721, 106 S.C.T 31 81, 92 L. Ed. 2d 583 (1986) (quoting *Youngstown Sheet & Tube Co. v. Sawyer*), 343 U.S. 579, 635, 72 S.C.T. 863, 96 L.Ed. 2d 1153 (1952)(Jackson, J; Concurring)

[6] *See, e.g.,* George F. Will*, A Government agency answerable to no one*, Wash. Post, November 16, 2012, Mark Tapscott, *Whatever Happened to a "government of laws, not of men'?,* Wash. Exam., November 1, 2012.

[7] See, 12 U.S.C. §5512(b)

[8] See, 12 U.S.C. §5514(a)(2) authorizing the CFPB to issue  rules to define the persons' that are subject to its regulatory oversight.  For example, in 2015 the CFPB issued a rule exercising regulatory oversight of the larger participants in indirect auto lending.

[9] See, 12 U.S.C. §5562

[10] See, 12 U.S.C. §12 U.S.C. §5563

[11] See, 12 U.S.C. §5491(c)

[12] *PHH Corporation, et. al. v. Consumer Financial Protection Bureau*, 839 F. 3d 1 17 (D.C. Cir. 2016); (opinion vacated pending *en banc* review)

**A Classic Example the Use of Consolidated Power**

The risk associated with the concentration of power in the CFPB is aptly illustrated by the *PHH* litigation in which a panel of the D.C. Circuit held that the structure of the CFPB was unconstitutional. Prior to the enactment of Dodd-Frank, the Department of Housing & Urban Development (HUD) was charged with the responsibility for regulating housing issues under a number of statutes, including the Real Estate Settlements Procedure Act (RESPA). RESPA, and its implementing regulations, prohibit the payment of "referral fees" in the context of real estate settlement services (it is believed that such referral fees are effectively "kickbacks" that increase the cost of settlement services charged to consumers). HUD had historically interpreted the relevant provision of RESPA as not being violated so long as a service provider was not paid more than the reasonable value for the services it rendered.

PHH is a large home mortgage lender. When PHH (and other lenders) provide mortgage loans to homebuyers, they require certain homebuyers to obtain mortgage insurance that protects the lender in the event the homebuyer defaults on the mortgage. In turn, mortgage insurers may obtain mortgage reinsurance to reduce their risk in the event the homebuyer defaults on the mortgage. In 1994, PHH established a subsidiary (Atrium Insurance Corporation) to provide reinsurance to the mortgage insurers that insured the mortgages generated by PHH (in industry terms, a "captive re-insurer"). PHH often referred borrowers to mortgage issuers that used Atrium's reinsurance services. Historically, HUD interpreted the relevant provisions of RESPA to authorize "captive re-insurance" arrangements, provided however, that the mortgage issuer paid the re-insurer no more than the reasonable market value for the reinsurance. Thus, for many years, PHH operated a captive re-issuer in a manner that it believed was consistent with HUD regulations.

When the CFPB was created in 2011, regulatory enforcement of RESPA was moved from HUD to the CFPB. The CFPB reinterpreted the provisions of RESPA in a manner different than had been previously interpreted by HUD (this is in the nature of a legislative action taken by the CFPB), and initiated an enforcement action against PHH (this being in the nature of an executive/prosecutorial action). PHH disputed the enforcement action and the matter was tried before an administrative law judge (ALJ)[13] who agreed with the new interpretation of RESPA promulgated by the CFPB and assessed a penalty against PHH in the amount of $6.4 million. PHH appealed the ALJ decision to the director of the CFPB (as such, the CFPB was exercising judicial power). The director of the CFPB concluded that the ALJ decision was wrong because (a) the ALJ should not have applied the three-year statute of limitations to the CFPB's regulatory action, and (b) as a consequence, the director of the CFPB increased the amount of the penalty assessed against PHH to approximately $109 million. As the PHH case illustrates, the structure of the CFPB is set up so that the director of the CFPB acts as legislator, prosecutor and judge.

On petition for review to the D.C. Circuit, PHH argued that, as structured, the CFPB was unconstitutional. The D.C. Circuit panel focused its decision on the fact that the director of the CFPB could only be removed for cause and, as a consequence, was not subject to effective oversight by the president.[14] As such, the D.C. Circuit (in a 2-1 ruling) in an opinion by Judge Brett Kavanaugh held that the structure of the CFPB was unconstitutional. However, the D.C. Circuit concluded that the structural problems with the CFPB could be corrected by authorizing the president to terminate the director of the CFPB for any reason.

The litigation between PHH and the CRPB is continuing. Subsequent to the panel decision being issued in October 2016, the CFPB petitioned the D.C. Circuit for *en banc* review of the panel decision, which was granted on February 16, 2017. Further, the panel decision was vacated pending the en banc decision.

[13] ALJ could have been an employee of the CFPB, but in this instance was an employee of the SEC.

[14] Historically, independent agencies exercising substantial executive power have been headed by a multiple-member board or commission. Thus, each individual board member or commissioner is accountable to and checked by their fellow board members or commissioners. In contrast, the CFPB is headed by a single director, who has unilateral authority to enforce the 19 federal consumer protection statutes under its purview. *See, PHH Corporation,* 839 at 17-18.

The full D.C. Circuit conducted oral arguments on May 24, 2017, and a decision is pending. It is fully expected that once the D.C. Circuit issues its decision, the losing party to the PHH appeal will request a review of the decision by the Supreme Court.

**Reform of the CFPB**

In light of the questions that exist about the constitutionality of the structure of the CFPB, the House of Representatives has proposed a restructuring of the CFPB. In our next client alert, Hunton & Williams will discuss the proposed restructuring of the CFPB in the Financial Choice Act.

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