

Client Alert

February 2018

DC Circuit Court of Appeals Finds Structure of CFPB to be Constitutional: What The Most Recent PHH Mortgage Decision Means for You

The financial world waited with bated breath for the *en banc* decision of the DC Circuit Court of Appeals (the *En Banc* Court) in *PHH Corporation, et al. v. Consumer Financial Protection Bureau*, No. 15-1177, 2018 U.S. App. LEXIS 2336 (D.C. Cir. Jan. 31, 2018). Finally, on January 31, 2018, the *En Banc* Court issued an opinion overruling in part and reinstating in part the October 2016 decision from a panel of the DC Circuit Court of Appeals (The Panel) that held, in part, the Consumer Financial Protection Bureau's (CFPB) structure to be unconstitutional. The Panel held this because the CFPB's single director, who may only be removed "for cause," was not subject to the requisite checks and balances and had too much authority to act autonomously. On rehearing, the *En Banc* Court disagreed, finding that there exists sufficient precedent to find that the "for cause" removal requirement does not violate Article II of the Constitution. However, the *En Banc* Court also reinstated the October 2016 ruling in favor of PHH, which (a) rejected the CFPB's new interpretation of Section 8(c)(2) of the Real Estate Settlement Procedures Act (RESPA); (b) held that the CFPB is bound by statutes of limitations in administrative actions; and (c) held that the CFPB may not retroactively apply rule changes or new interpretations in enforcement actions that are inconsistent with prior regulatory guidance or interpretations.

A Little Bit of Background

This matter arose from an investigation by the CFPB into PHH's captive reinsurance practices and their validity under Section 8 of RESPA, which prohibits kickbacks in exchange for the referral of settlement service business. However, Section 8(c)(2) of RESPA provides that nothing in Section 8 prohibits reasonable payments in return for goods, facilities or services actually provided. PHH, a large home mortgage lender, referred its borrowers to mortgage insurers. These insurers would, in turn, purchase reinsurance to protect themselves in the event of default. In 1994, PHH established Atrium, which was a wholly owned subsidiary of PHH, and sold reinsurance to the insurers to which PHH referred its borrowers.

When HUD had enforcement authority over RESPA, it had issued guidance indicating that captive reinsurance arrangements are permissible under RESPA Section 8, provided that the amounts paid by the mortgage insurer do not exceed the reasonable fair market value for the reinsurance. If the payment is more than the reasonable value, the excess payment may be viewed as a disguised payment for a referral in violation of RESPA Section 8. PHH structured its practices with Atrium with the intent to comply with HUD's interpretation of RESPA Section 8.

The CFPB launched an investigation into PHH's mortgage reinsurance arrangements and, in 2014, began an administrative enforcement action against PHH. The CFPB issued a new interpretation of Section 8(c) of RESPA to provide that captive reinsurance arrangements are impermissible under RESPA Section 8, taking the position that Section 8(c)(2) of RESPA is not a substantive exemption to the anti-kickback provisions of Section 8 of RESPA. The CFPB then applied this interpretation retroactively, finding PHH to be in violation of RESPA for its captive reinsurance arrangements dating all the way back to Atrium's creation, despite PHH's having acted in reliance on HUD's prior interpretation of RESPA. In the enforcement action, an administrative law judge issued disgorgement sanctions against PHH in the

amount of \$6.4 million. The decision of the administrative law judge was reviewed by the director of the CFPB (Richard Cordray) who increased the award, ordered PHH to pay \$109 million to disgorge all its mortgage reinsurance premiums over the last 20 years and issued an injunction preventing PHH from entering into any further captive reinsurance arrangements.

PHH appealed the decision of the director of the CFPB to the DC Circuit and challenged the enforcement action on multiple grounds. First, PHH contended that the CFPB was bound by the three-year statute of limitations in its administrative actions. Second, PHH argued that the CFPB incorrectly reinterpreted RESPA Section 8(c) to prohibit captive reinsurance. Third, PHH claimed that the CFPB violated PHH's due process rights by applying its new interpretation of RESPA retroactively, when PHH had justifiably relied on HUD's prior interpretation. Finally, PHH argued that the CFPB is an unconstitutional body, operating in violation of Article II of the Constitution, because it is headed by a single director who can only be removed for cause and not by a commission.

On October 11, 2016, the Panel ruled in favor of PHH on all counts, finding that (1) the CFPB is bound by the applicable statute of limitations articulated in the 19 consumer protection statutes adjudicated by the CFPB; (2) RESPA permits captive reinsurance arrangements, provided that the compensation is consistent with the value of the services being provided; (3) the CFPB violated PHH's due process rights by retroactively applying its new interpretation of RESPA Section 8(c); and (4) the CFPB's structure is unconstitutional and the Panel therefore struck the "for cause" removal provision so that the president could remove the director at will.

The CFPB appealed the ruling to the *En Banc* Court. On January 31, 2018, the *En Banc* Court reversed the October 2016 ruling finding the CFPB to be an unconstitutional body. However, in doing so, it reinstated the remainder of the October 2016 ruling in favor of PHH as to the CFPB's disgorgement action.

The En Banc Court's Ruling

At present, the CFPB is structured such that one director, heading the Bureau, serves a five-year term, and may only be removed from the position "for cause." The president holds the power to terminate the director only for "inefficiency, neglect of duty, or malfeasance in office." PHH argued, and the Panel agreed, that this structure affords the director too much unfettered power. The *En Banc* Court, however, disagreed.

First, the *En Banc* Court considered whether the "for cause" removal provision violates Article II of the Constitution. Pointing to decades of Supreme Court precedent, the Panel determined that the "for cause" removal provision is consistent with "a longstanding tradition of independence for financial regulators, and [is] squarely supported by established precedent." *PHH*, 2018 U.S. App. at *47. In so finding, the panel compared the CFPB to the FTC. While the FTC is governed by the commission whose members are removable only for cause, the FTC's structure has been approved by a unanimous Supreme Court. Consequently, the *En Banc* Court concluded that it was bound by this precedent.

Next, the *En Banc* Court considered whether CFPB's ability to collect funding from the Federal Reserve as opposed to the congressional appropriations process was constitutional. However, the *En Banc* Court held that "the way the CFPB is funded fits within the tradition of independent financial regulators." *Id.* at *54. Thus, the *En Banc* Court concluded that the CFPB's ability to obtain independent funding does not unconstitutionally impinge on the Congress' oversight power.

Ultimately, the panel found that the overwhelming weight of "binding Supreme Court precedent" outweighed any argument that the CFPB's structure is unconstitutional. *Id.* at 94. In the end, however, although PHH lost its argument regarding the constitutionality of the CFPB, it still came out the winner, as the panel unanimously upheld the October 2016 ruling to vacate the CFPB's disgorgement judgment against PHH.

What Does This Decision Mean For You?

It's unclear what PHH might do from here. In theory, PHH could attempt to appeal the decision to the Supreme Court. However, given that PHH won the underlying claim against the CFPB on the RESPA issue, the Supreme Court may refuse to hear the case because there is no harm for the Court to resolve. Furthermore, given the current political climate, pursuing an appeal may be a moot point. With Mick Mulvaney at its helm, the CFPB has started to show a sea change as to its previously aggressive enforcement policies. In addition, during the pendency of this case, the Trump administration threw its support behind PHH, signaling a major change in the CFPB's attitude toward the financial services industry. Therefore, an appeal to the Supreme Court could be a very costly exercise with little to no practical benefit.

However, regardless of whether PHH pursues an appeal, in unanimously reinstating the DC Circuit's October 2016 ruling as to the RESPA issues, the decision has some important implications for the settlement services industry. The decision may provide support for other activities that rely on the Section 8(c)(2) exemption, such as marketing services agreements (MSAs), desk rentals and other advertising arrangements. The CFPB's interpretation of Section 8(c) has led to uncertainty as to whether such arrangements are permissible under RESPA Section 8. However, it remains as important as ever to carefully consider the implications of these types of arrangements and to ensure that any payments reflect the fair market value for the goods, facilities and services actually provided.

Finally, this ruling will have a tremendous impact on future enforcement actions which the CFPB may bring. While the CFPB may have the authority to reinterpret a given statute or regulation on a going-forward basis, it is now clear that it cannot apply the new interpretation retroactively. In other words, the CFPB may not bring an enforcement action based on conduct that was explicitly permitted by regulatory guidance or interpretations and which occurred prior to their new interpretation.

Conclusion

It remains to be seen how PHH will choose to proceed from here. In the words of Judge Tatel, who wrote the concurrence, "PHH is free to ask the Supreme Court to revisit [precedent], but that argument has no truck in a circuit court of appeals." That being said, even if PHH declines to pursue an appeal to the Supreme Court, one thing is clear: this decision has changed the landscape for CFPB enforcement actions.

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