SULLIVAN & CROMWELL LLP

August 7, 2015

D.C. Circuit Allows Challenges to the CFPB's Constitutionality to Proceed

Separate Panels Reverse District Court Dismissal of Texas Bank's Challenges on Standing and Ripeness Grounds and Grant Mortgage Servicer's Motion to Stay CFPB Action Pending Judicial Review

SUMMARY

On July 24, 2015, a panel of the U.S. Court of Appeals for the D.C. Circuit held that State National Bank of Big Spring (the "Bank"), a Texas bank with total assets of approximately $313 million, can challenge the constitutionality of the Consumer Financial Protection Bureau and the recess appointment of its director, Richard Cordray. In so doing, the D.C. Circuit overturned, in part, a decision of the U.S. District Court for the District of Columbia, which dismissed the Bank's claims on lack of standing and ripeness grounds.[1] Unless further review is sought, the District Court must now consider the merits of the Bank's challenges. Just over a week later, on August 3, 2015, a different panel of the D.C. Circuit granted a motion by PHH Corporation, a mortgage servicer, and certain affiliates to stay pending judicial review of Director Cordray's June 4, 2015 administrative decision and final order finding that PHH illegally referred consumers to mortgage insurers in exchange for kickbacks and ordering injunctive relief and disgorgement. In both the motion to stay and separate statement of issues to be raised on appeal, PHH indicates that it too intends to challenge, among other things, the constitutionality of the CFPB's structure.[2] In granting PHH's motion for a stay, the D.C. Circuit concluded that PHH "satisfied the stringent requirements for a stay pending appeal."[3] Although it is impossible to gauge the ultimate outcome of either case, success on the merits by the Bank or PHH could have significant implications for institutions regulated by the CFPB.

BACKGROUND

A. SEPARATION OF POWERS

Separation-of-powers principles prevent Congress from bestowing overly vague or unbridled grants of authority on others, effectively allowing them to legislate in its place. Such principles also limit Congress's ability to insulate executive officers from presidential control through job tenure protection. Dodd-Frank confers broad authority on the CFPB to "regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws"[4] and to implement those laws through "rules, orders, guidance, interpretations, statements of policy, examinations, and enforcement actions."[5] Under the Act, the CFPB is headed by a single Director, appointed by the President with the advice and consent of the Senate, and removable by the President only for cause (*i.e.*, inefficiency, neglect of duty, or malfeasance in office).[6] Further, the CFPB is funded by the Federal Reserve System, not congressional appropriation, and Dodd-Frank provides that such funding is not subject to congressional review.[7]

The Bank contends that Dodd-Frank's delegation of "effectively unlimited power" to the CFPB, funding of the CFPB outside the congressional appropriations process, and restrictions on the President's authority to remove an executive officer violate separation-of-powers principles. The District Court held that the Bank did not have standing and that this claim was not ripe. The D.C. Circuit disagreed, concluding that the Bank's status as an entity regulated by the CFPB confers standing and that the claim is ripe because regulated parties generally need not violate the law in order to challenge the legality of the regulating agency itself. The D.C. Circuit therefore remanded for consideration on the merits.

PHH similarly asserts that the "unprecedented structural features of the CFPB"—namely, the placement of legislative, executive, and judicial power all in the hands of a single director who is not answerable to the President or Congress—violate separation-of-powers principles.[8] Although the constitutionality of the CFPB's structure is only one of several issues PHH intends to raise on appeal, in granting PHH's motion to stay Director Cordray's decision and final order, the D.C. Circuit necessarily considered the likelihood that PHH will prevail on the merits and ultimately concluded that PHH "satisfied the stringent requirements for a stay pending appeal."[9]

B. RECESS APPOINTMENTS

The Constitution generally requires the President to obtain the advice and consent of the Senate when appointing individuals to high level government positions—so-called "officers" of the United States. However, the President may unilaterally "fill up all Vacancies that may happen during the Recess of the Senate."[10] Facing increased resistance to his nominations, President Obama invoked his recess appointment power to name Richard Cordray as Director of the CFPB without Senate approval on January 4, 2012, during a three-day break in Senate *pro forma* sessions[11] (also known as an "intra-session" recess). Director Cordray was subsequently confirmed by the Senate on July 16, 2013. On

August 30, 2013, he published a "Notice of Ratification" in which he stated: "I believe that the actions I took during the period I was serving as a recess appointee were legally authorized and entirely proper. To avoid any possible uncertainty, however, I hereby affirm and ratify any and all actions I took during that period."[12]

The Bank challenged Director Cordray's recess appointment as unconstitutional, but the District Court also dismissed this claim for lack of standing and on ripeness grounds. On August 2, 2013, the Bank appealed to the D.C. Circuit. While the appeal was pending, on June 26, 2014, the Supreme Court decided *NLRB* v. *Noel Canning*—a case challenging the President's intra-session recess appointments of three NLRB Commissioners.[13] The Court held that the Senate has prerogative to say when it is (or is not) in session, "provided that, under its own rules, it retains the capacity to transact Senate business."[14] According to the Court, an intra-session recess does not count as a "recess" for the purpose of recess appointments because the Senate claims to be "in session" and retains the power to conduct business, even if the power is not exercised. Further, although the recess appointments power is available during both an inter-session recess and "an intra-session recess of substantial length," a break of three days is "constitutionally *de minimis*."[15] The intra-session recess appointments of the three NLRB Commissioners were therefore invalid.

Considering the Bank's appeal, the D.C. Circuit concluded that, for the same reasons the Bank could pursue the first claim, the Bank had standing to challenge Director Cordray's recess appointment and that the claim is ripe. Accordingly, the D.C. Circuit remanded for "consideration of the merits of this issue in light of the Supreme Court's decision in *Noel Canning*. . . . In considering the Bank's claim, we leave it to the District Court to consider the significance of Director Cordray's later Senate confirmation and his subsequent ratification of the actions he had taken while serving under a recess appointment."[16]

IMPLICATIONS

Absent a petition for rehearing or Supreme Court review, the District Court must now consider the merits of the Bank's challenges to the constitutionality of both the CFPB and the recess appointment of Director Cordray. Similarly, to the extent PHH ultimately chooses to challenge the CFPB's constitutionality on appeal, it seems likely the D.C. Circuit will consider the merits of that challenge. The U.S. Court of Appeals for the Seventh Circuit is also squarely presented with a challenge to the CFPB's constitutionality.[17] Although it is impossible to predict how these courts might rule, decisions on the merits of the Bank's claims could have important implications for regulated institutions.

If Congress's delegation of authority to the CFPB were deemed unconstitutional, every CFPB action would be subject to challenge. Although that seems unlikely, courts could adopt limits on the CFPB's authority—either through interpretation of Dodd-Frank or by invalidating and severing certain provisions of Dodd-Frank—to avoid or remedy the constitutional difficulties. Similarly, if the single-headed structure of the CFPB is deemed unconstitutional, then every CFPB action could be open to challenge. Again, to

avoid the consequences of such a ruling, a court could sever the tenure provision from Dodd-Frank and deem the Director removable at the will of the President.[18] Finally, a court could conclude that such an extensive grant of authority *combined* with tenure protection in a single agency head and funding outside congressional review removes the CFPB so far from the control of any branch of government as to be unconstitutional. But again, the likely remedy would be to sever the tenure provision or require appropriations to come from Congress, not to declare the CFPB unconstitutional.

The intra-session recess appointment of Director Cordray falls squarely within the holding of *Noel Canning* and was thus of doubtful constitutionality—the Director received his initial commission at the same time and in the same manner as the three NLRB appointees. *Noel Canning* therefore provides parties solid ground to challenge the validity of adverse CFPB action by the Director.[19] However, unlike the NLRB, after Director Cordray was subsequently confirmed by the Senate, he took the additional step of affirming and ratifying any and all actions previously undertaken as a recess appointee. The effect of attempted ratification on prior agency action remains unclear and the D.C. Circuit intentionally left the issue to be decided by the District Court in the first instance. The Bank could argue that blanket ratification violates the Due Process Clause of the Constitution or the statutory procedural requirements of the Administrative Procedure Act, given that parties were not afforded individual consideration of their claims by a valid decision maker. Should a court agree with such a far-reaching argument, all actions taken pursuant to the recess appointment could be invalidated.

Further muddying the waters is the current political debate involving the CFPB, which has been criticized by some for lack of transparency and insufficient congressional oversight. As a result, legislation has been introduced that would replace the single CFPB Director with a five-member commission and subject the CFPB to the normal congressional appropriations process.[20] If enacted, these legislative proposals would potentially remedy the purported constitutional infirmities, rendering moot certain prospective claims but not necessarily nullifying claims relating to decisions made by a director with an invalid appointment or while some aspect of the CFPB was otherwise unconstitutional.

Only time will tell whether these challenges to the CFPB's constitutionality or Congress's attempts at legislative changes to the CFPB's governance or funding will succeed. It is quite possible courts will ultimately conclude there is no constitutional defect. In the meantime, the CFPB does not appear to be adjusting its approach to regulation in response to these constitutional challenges.

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ENDNOTES

[1] *State Nat'l Bank of Big Spring* v. *Lew*, No. 13-5247, 2015 WL 4489885 (D.C. Cir. July 24, 2015). The D.C. Circuit affirmed the dismissal of additional claims challenging the constitutionality of the Financial Stability Oversight Council and "orderly liquidation authority" under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"). On May 1, 2015, in an unrelated case, the same panel (with one judge dissenting) affirmed dismissal of a complaint for injunctive and declaratory relief in which the appellants also challenged the CFPB's constitutionality, concluding that one appellant lacked standing and the other had an adequate remedy at law. *See Morgan Drexen, Inc.* v. *CFPB*, 785 F.3d 684 (D.C. Cir. 2015)

[2] PHH indicates that it also intends to challenge on due process grounds the CFPB's retroactive application of new interpretations of RESPA to prohibit conduct that was, at the time of the conduct, expressly permitted by agency regulations and guidance, as well as various other aspects of the decision and order.

[3] Order, *PHH Corp.* v. *CFPB*, No. 15-1177 (D.C. Cir. Aug. 3, 2015).

[4] 12 U.S.C. § 5491(a)

[5] 12 U.S.C. § 5492(a)(10).

[6] 12 U.S.C. § 5491(b) & (c).

[7] 12 U.S.C. § 5497(a).

[8] Motion of Petitioners for Stay Pending Judicial Review at 12, *PHH Corp.* v. *CFPB*, No. 15-1177 (D.C. Cir. June 26, 2015).

[9] Other factors the court necessarily considered include the prospect of irreparable injury to PHH if relief is withheld, the possibility of substantial harm to other parties if relief is granted, and the public interest.

[10] U.S. Const. art. II, § 2, cl. 3.

[11] A *pro forma* session is a brief meeting of the Senate, often lasting only a few minutes.

[12] 78 Fed. Reg. 53734 (Aug. 30, 2013).

[13] *N.L.R.B.* v. *Noel Canning*, 134 S. Ct. 2550 (2014). These appointments, like the appointment of Director Cordray, occurred on January 4, 2012.

[14] *Id.* at 2574.

[15] *Id.* at 2566.

[16] *State Nat'l Bank of Big Spring* v. *Lew*, No. 13-5247, 2015 WL 4489885, at *3 (D.C. Cir. July 24, 2015).

[17] *CFPB v. ITT Educ. Servs.*, Inc. No. 15-1761 (7th Cir. Filed Apr. 8, 2015).

[18] *See, e.g.*, *Free Enter. Fund* v. *Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010).

[19] Director Cordray served without a Senate-confirmed appointment from January 4, 2012 to July 16, 2013. It is also possible that litigants might challenge actions taken by the Federal Deposit Insurance Corporation or the Financial Stability Oversight Council during the period when Director Cordray was not properly appointed yet sitting as a member of their boards. The federal government has various defenses to these types of challenges, and it is difficult to predict whether any would succeed.

[20] At the extreme, bills have been introduced that would eliminate the CFPB altogether.

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