

Alert | Financial Services Litigation



October 2022

Here We Go Again: Fifth Circuit Rules CFPB’s Funding Mechanism Is Unconstitutional, Vacates Payday Lending Rule

On Oct. 19, 2022, a three-judge panel of the United States Court of Appeals for the Fifth Circuit ruled that the funding mechanism for the Consumer Financial Protection Bureau (CFPB) violates the appropriations clause of the Constitution, and as a result vacated the CFPB’s 2017 payday lending rule. In the case *Community Financial Services of America v. Consumer Financial Protection Bureau*, (“*Community Financial*”) the court held that the independent funding of the CFPB via the Federal Reserve is constitutionally infirm, and moreover that the Payday Lending Rule was only made possible by this unconstitutional source of funding and should be vacated. While the CFPB will almost certainly seek rehearing *en banc* or appeal to the Supreme Court, the ruling calls into question the validity of all rulemaking and enforcement activities undertaken by the CFPB since its inception.

Background

Since the CFPB was created, numerous parties have challenged its structure as unconstitutional. In the case of *Seila Law, LLC v. Consumer Financial Protection Bureau*, the Supreme Court ruled that the structure of a single director-led agency only removable by the President “for cause” violated the separation of powers clause. Notably, however, the Court found that provision to be severable, and accordingly simply invalidated the “for cause” requirement in the Dodd-Frank Act, essentially amending Dodd-Frank to allow the CFPB director to be removed at the discretion of the president. Rather than

invalidating the action being undertaken by the CFPB in *Seila Law*, the Court remanded that case to the trial court to assess the impact on the civil enforcement proceeding.¹

In *Community Financial* the Plaintiffs² sued the Bureau in 2018 on behalf of payday lenders and credit access businesses, seeking an order setting aside the 2017 Payday Lending Rule (“the Rule”), alleging that the Rule violated the CFPB’s statutory authority and, among other arguments, that the rulemaking authority violated the Constitution’s separation of powers. The Rule, which regulates payday, vehicle title, and other types of consumer loans, had been proposed in 2016 under Director Richard Cordray, became final in 2017 and effective in 2018. The Rule generally prohibits what the Bureau deemed to be unfair and abusive practices in the underwriting, payment, and collections of such loans. The plaintiffs specifically challenged sections related to limitations on a lender’s ability to obtain loan repayments via preauthorized account access. *See* 12 C.F.R. § 1041.8. Essentially, the Rule prohibits any additional attempts to withdraw payments from accounts after two consecutive withdrawal attempts have failed due to a lack of sufficient funds.

While the case was pending, under Acting Director Mick Mulvaney, the CFPB issued a new notice-and-comment period to consider revisions to the Rule. The district court in *Community Financial* issued a stay while that process was ongoing. Eventually, under Director Kathy Kraninger, the CFPB issued a new proposed rule rescinding the underwriting portions of the Rule but leaving the payment provisions intact. Moreover, following the Supreme Court’s Ruling in *Seila Law*, Director Kraninger finalized the revised rule and issued a “ratification” of the Rule. The district court then lifted the stay, and the parties filed respective motions for summary judgment. The district court granted summary judgment for the CFPB, ruling that (1) the Director’s insulation from removal did not render the Rule void *ab initio*, (2) the Director’s ratification of the Rule was a solution to any constitutional injury sustained by plaintiffs, (3) the Rule was within the CFPB’s authority and not arbitrary or capricious, (4) the funding mechanism of the CFPB did not violate the Appropriations Clause, and (5) the CFPB’s action did not violate the nondelegation doctrine.

The Fifth Circuit Ruling

On appeal, the Fifth Circuit essentially sided with the CFPB on all issues except one, albeit a crucial one in terms of impact. The Court ruled that the CFPB acted within its authority in issuing the Rule, and that the CFPB was not acting arbitrarily or capriciously in enacting the Rule. Moreover, the court held that Plaintiffs did not show that the Director’s insulation from removal at the time the rule was promulgated created a concrete harm to the Plaintiffs, and as a result did not even need to consider whether the ratification by Director Kraninger cured that harm. The Court further ruled that the Rule did not violate the nondelegation doctrine, as the language of the Dodd-Frank Act creating the CFPB set forth an “intelligible principle” to guide the discretion of the CFPB, namely to “implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive” and to protect against “unlawful unfair, deceptive, or abusive acts or practices” in connection with consumer finance.³

However, on the issue of whether the CFPB’s funding structure violates the Appropriations Clause, the Court ruled in favor of the Plaintiffs. The Court highlighted that the CFPB, unlike most other federal agencies, is not subject to annual appropriations from Congress. Rather, the CFPB is funded by the

¹ In a concurring opinion, Justices Thomas and Gorsuch ruled that they would have invalidated the civil investigative demand.

² The Plaintiffs are Community Financial Services Association of America, Limited (a national trade association) and Consumer Service Alliance of Texas (a Texas trade association).

³ 12 U.S.C. §§ 5511(a), 5531(b).

Federal Reserve, with the only restriction being that the Director submit an amount determined to be “reasonably necessary to carry out” its functions, and that the amount not exceed 12% of the Federal Reserve’s total operating expenses.⁴ The Court further highlighted that the Federal Reserve is *itself* outside of the appropriations process through bank assessments, and that any funds transferred to or acquired by the CFPB are kept in a fund under the exclusive control of CFPB’s Director, further insulating it from congressional oversight. The Court found that these multiple levels of insulation from the appropriations process amounted to “an off-books charge card that rings up ‘[un]appropriated monies’” and that Congress “ran afoul of the separation of powers embodied in the Appropriations Clause” in approving such a funding structure.⁵

The Court went on to rule that the Plaintiffs had easily shown a direct harm due to this constitutional issue, “because the funding employed by the Bureau to promulgate the Payday Lending Rule was wholly drawn through the agency’s unconstitutional funding scheme.” Plaintiffs were held to be entitled to “a rewinding of [the Bureau’s] action.”⁶ The Court rendered judgment for the Plaintiffs on this claim, vacating the Rule.

Impact

The CFPB may either seek rehearing *en banc* before the full Fifth Circuit or petition the Supreme Court for *certiorari*. An *en banc* consideration of the decision may not be worthwhile, as the Fifth Circuit is not perceived as favorably disposed to the CFPB’s position. The Bureau has about 50 days to act. The Fifth Circuit’s panel decision may be stayed as the case progresses without any immediate impact on the CFPB’s operations. But the ruling has broad and far-reaching implications for the agency’s future.

For example, if this decision is upheld on *en banc* review, by the Supreme Court, or is endorsed by other courts, it could impact all rulemaking *and* enforcement activities that the CFPB has undertaken since its inception, given that potentially all such actions could be challenged as being funded by an unconstitutional mechanism. Likewise, it would create a funding crisis for the Bureau, as neither the *en banc* Fifth Circuit nor the Supreme Court would be able to provide a replacement funding mechanism for the Bureau, pushing the “fix” to what may well be a divided or Republican-controlled Congress.

Meanwhile, financial services companies will continue to articulate such arguments in response to the CFPB’s administrative proceedings, civil investigative demands, and even enforcement proceedings, all of which rely on a source of funding which a circuit court of appeals has now ruled is unconstitutional. Although litigants would need to show that the unconstitutional funding mechanism caused them specific harm, the Fifth Circuit’s ruling “make[es] that showing [] straightforward” by holding that “the funding employed by the Bureau to promulgate the Payday Lending Rule was wholly drawn through the agency’s unconstitutional funding scheme, [and therefore] there is a linear nexus between the infirm provision (the Bureau’s funding mechanism) and the challenged action (promulgation of the rule).”⁷

Similar logic would appear to apply to all regulations promulgated by the CFPB since its inception, including, but not limited to, the Mortgage Servicing Rules, the Ability to Repay and Qualified Mortgage Rules, the Integrated Mortgage Loan Disclosures Rule, and the recent Debt Collection Rules. But financial services companies may argue that even CFPB enforcement activities under laws and regulations that

⁴ 12 U.S.C. § 5497(a).

⁵ *Community Financial* at 31-32.

⁶ *Id.* at 38, citing *Collins v. Yellen*, 141 S. Ct. 1761, 1801 (2021).

⁷ *Id.* at 38.

were not promulgated by the CFPB are unconstitutional, since the CFPB is only able to undertake such enforcement activity through a constitutionally impermissible source of funding.

Given the current composition of the Supreme Court, the Supreme Court's prior willingness to declare aspects of Dodd-Frank unconstitutional in *Seila Law*, along with the long odds of Congress passing legislation that would address this issue in an election year or afterwards, this issue may well remain unresolved for the near term. The CFPB is not expected to alter its current priorities, agenda, and approach to oversight of consumer financial products and services. Companies should continue to focus on compliance and risk mitigation.

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